

Am I My Borrower's Keeper?

KERRY L. MACINTOSH*

And the Lord said unto Cain, Where is Abel thy Brother? And he said, I know not: Am I my brother's keeper?¹

Suppose a lender is asked to make a substantial loan to a prospective borrower. The lender possesses information indicating that the borrower will use the loan proceeds to finance an activity that, although legitimate on its face, is conducted in violation of regulatory provisions. Nevertheless, the lender makes the loan because it promises to be profitable. Later the borrower defaults, and the lender goes to court to enforce the debt and realize on its security interest in the borrower's property. There, the borrower raises the regulatory violations as a defense. Imagine the lender's consternation, and probable response: "What business is it of mine what the borrower does with the money? Am I my borrower's keeper?"

This hypothetical is not as improbable as it might seem. The Supreme Court's recent decision in *Citicorp Industrial Credit, Inc. v. Brock*² indicates that sentiment in favor of holding lenders responsible for borrower misconduct may be increasing. In *Citicorp*, a lender sought to realize on its perfected security interest in the borrower's inventory. The inventory included goods produced by employees who had not been paid for their labor in violation of sections 6 and 7 of the Fair Labor Standards Act (FLSA), because of the borrower's deteriorating financial condition.³ Relying upon section 15(a)(1) of the Act,⁴ the Secretary of Labor obtained preliminary injunctions prohibiting the lender from shipping these "hot goods" in interstate commerce.⁵ The Supreme Court affirmed, holding that the Act's broad prohibition of

* Associate Professor of Law, University of Colorado School of Law. B.A. 1978, Pomona College; J.D. 1982, Stanford University.

Thanks are due to the many colleagues who reviewed earlier drafts of this Article and offered valuable suggestions, including Professors Arthur Travers, Steven Smith, and Theresa Gabaldon of the University of Colorado School of Law, and Professors Douglas Laycock, Jay Westbrook, and Richard Wright of the University of Texas School of Law. I also thank James Witwer, Craig Weinberg, and Christie Bachmeyer, J.D. 1989, University of Colorado School of Law, for their capable and diligent research assistance.

1. *Genesis* 4:9 (King James).

2. 483 U.S. 27 (1987).

3. 29 U.S.C. §§ 206-207 (1982).

4. *Id.* § 215(a)(1). This provision states:

(a) . . . [I]t shall be unlawful for any person—

(1) to transport, offer for transportation, ship, deliver, or sell in commerce, or to ship, deliver, or sell with knowledge that shipment or delivery or sale thereof in commerce is intended, any goods in the production of which any employee was employed in violation of section 206, or section 207 of this title, or in violation of any regulation or order of the Secretary issued under section 214 of this title; except that no provision of this chapter shall impose any liability upon any common carrier for the transportation in commerce in the regular course of its business of any goods not produced by such common carrier, and no provision of this chapter shall excuse any common carrier from its obligation to accept any goods for transportation; and except that any such transportation, offer, shipment, delivery, or sale of such goods by a purchaser who acquired them in good faith in reliance on written assurance from the producer that the goods were produced in compliance with the requirements of this chapter, and who acquired such goods for value without notice of any such violation, shall not be deemed unlawful. . . .

5. The Secretary of Labor obtained injunctions in two different United States District Courts. *Ford v. Ely Group, Inc.*, 621 F. Supp. 22 (W.D. Tenn. 1985); *Donovan v. Rockford Textile Mills, Inc.*, 608 F. Supp. 215 (E.D. Tenn. 1985). These actions were consolidated on appeal and affirmed by the United States Court of Appeals for the Sixth

interstate shipment of "hot goods" by "any person" included creditors who acquired goods pursuant to a security agreement.⁶ The practical effect of this holding was that the lender, in order to realize on its security interest, had to cure the borrower's violation by paying the employees their wages.⁷

Although the *Citicorp* decision shocked lenders,⁸ some were reassured by the fact that its holding was limited to a narrow range of cases in which the "hot goods" provision of the Fair Labor Standards Act applied.⁹ However, the broad reasoning with which the Supreme Court supported its holding has implications beyond the context of "hot goods" cases:

[P]rohibiting foreclosing creditors from selling "hot goods" also advances the goal of [securing decent wages and hours for American workers]. Secured creditors often monitor closely the operations of employer-borrowers, as petitioner did in this case. They may be in a position to insist on compliance with the FLSA's minimum wage and overtime requirements.¹⁰

In other words, the Supreme Court interpreted the Act to prohibit foreclosing lenders from selling "hot goods" in an effort to deter violations of the Act by forcing lenders to police borrower conduct. The Court reasoned that it was fair to impose such responsibility upon lenders, because the financing they provided led to violations of the Act by allowing marginal borrowers to remain in business.¹¹

Could—or should—the *Citicorp* reasoning be extended beyond the context of the Fair Labor Standards Act? Could—or should—lenders be held responsible for the regulatory violations that their borrowers commit? If so, could—or should—the courts refuse to allow lenders to enforce loans and concomitant security interests, to discourage financing that facilitates regulatory violations?

This Article examines these and related questions, but within a different framework than was presented in *Citicorp*. There, the Secretary of Labor represented the interests of workers who were victimized when the borrower failed to pay their wages

Circuit. *Brock v. Ely Group, Inc.*, 788 F.2d 1200 (6th Cir. 1986), *aff'd sub nom. Citicorp Indus. Credit, Inc. v. Brock*, 483 U.S. 27.

6. *Citicorp*, 483 U.S. at 39.

7. *See id.* at 31 n.2. Despite this practical effect, the Court reasoned that its interpretation of the Act to include secured creditors did not grant the employees a lien on the "hot goods" superior to the lender's security interest. *Id.* at 38–39.

8. Back in 1966, the Second Circuit held that a lender which foreclosed its security interest in the borrower's inventory was not subject to the Act's injunction against introducing "hot goods" into interstate commerce. *Wirtz v. Powell Knitting Mills Co.*, 360 F.2d 730 (2d Cir. 1966). In 1971, the Fourth Circuit concurred. *Shultz v. Factors, Inc.*, 65 Lab. Cas. (CCH) ¶ 32,487 (4th Cir. 1971). Thus, in holding that the Act did indeed apply to secured creditors, the Supreme Court rejected an interpretation of the Act that had been accepted by the business community for over 20 years. Justice Stevens argued vigorously in his *Citicorp* dissent that the Second Circuit's interpretation of the Act should be retained given Congress' failure to purge that interpretation by amending the Act. *Citicorp*, 483 U.S. at 43 (Stevens, J., dissenting).

9. *Citicorp*, 483 U.S. at 39.

10. *Id.* at 37. Another policy objective of the Fair Labor Standards Act is elimination of the competitive advantage enjoyed by goods produced under substandard labor conditions. The Court concluded that application of § 15(a)(1) of the Act to secured creditors would further this goal as well by excluding "hot goods" from interstate commerce. *Id.* at 36–37.

For an interesting critique of the Court's reasoning, see Note, "Hot Goods" Liability: Secured Creditors and the Fair Labor Standards Act, 87 COLUM. L. REV. 644 (1987).

11. *See Citicorp Indus. Credit, Inc. v. Brock*, 483 U.S. 27, 38 (1987) (quoting *Ford v. Ely Group, Inc.*, 621 F. Supp. 22, 26 (W.D. Tenn. 1985)).

in violation of the Act. Thus, the posture of the case required the Supreme Court to take the interests of innocent third parties into account in determining whether the lender would be allowed to realize on its security interest. In contrast, this Article will address the ability of lenders to enforce loans and concomitant security interests against borrowers when the interests of innocent third parties are not directly involved.¹²

Part I of this Article describes certain common law rules that the courts have used to deny enforcement of contracts and discusses their policy underpinnings. Part II explains how these rules apply within the context of the lender-borrower relationship. Finally, Part III considers whether and under what circumstances the common law rules should be changed to impose greater responsibility upon lenders for borrower misconduct.

I. ENFORCEMENT OF IMPROPER USE CONTRACTS

Generally the courts characterize contracts that offend societal norms as "illegal contracts."¹³ There is no remedy for breach of an illegal contract.¹⁴ Moreover, restitution for performance rendered under an illegal contract is usually not available.¹⁵

Refusal to provide relief is not based upon concern for the welfare of the

12. This Article leaves for another day consideration of whether lenders should be allowed to enforce loans and concomitant security interests in cases like *Citicorp* when the interests of innocent third parties are directly involved.

Also beyond the scope of this Article is discussion of the circumstances under which lenders could be held criminally or civilly liable under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (1988), as a result of providing financing to borrowers engaged in improper activities.

13. See E. A. FARNSWORTH, *CONTRACTS* § 5.1, at 327 (1982).

The Restatement (Second) of Contracts addresses the enforceability, not of "illegal contracts," but rather of promises that offend public policy. See *RESTATEMENT (SECOND) OF CONTRACTS* § 178(1) (1979) [hereinafter *RESTATEMENT*]. There are two reasons for this choice of terminology. First, use of the term "illegal" is inappropriate because contract law is not concerned with the imposition of penalties or sanctions. Second, use of the term "contract" is inappropriate because often only one promise or term within the contract is unenforceable. See *id.* at introductory note to ch. 8, topic 1 (unenforceability in general).

To illustrate the latter point, suppose a law requiring all plumbers to be licensed is enacted for the purpose of protecting consumers against incompetent plumbers. A, an unlicensed plumber, agrees to repair plumbing in B's home, and B promises to pay \$1,000 in exchange. B's promise to pay \$1,000 for the unlicensed repair work is unenforceable by A on grounds of public policy. *Id.* § 181 comment c, illustration 2. However, because the licensing law exists for the protection of persons such as B, public policy does not render A's promise to perform competent repair work unenforceable, and B may recover damages from A if the work is defective. *Id.* at comment d, illustration 5.

14. See, e.g., *Wells v. Comstock*, 46 Cal. 2d 528, 297 P.2d 961 (1956); *Whitney v. Continental Life & Accident Co.*, 89 Idaho 96, 403 P.2d 573 (1965); *United Calendar Mfg. Corp. v. Huang*, 94 A.D.2d 176, 463 N.Y.S.2d 497 (1983); *Cooper v. Baer*, 59 Wash. 2d 763, 370 P.2d 871 (1962); see also *Kaiser Steel Corp. v. Mullins*, 455 U.S. 72, 77 (1982) (illegal contract term is not enforceable).

The Restatement (Second) of Contracts states that a promise or other term may not be enforced when the interest in its enforcement is outweighed by a public policy against enforcement. *RESTATEMENT*, *supra* note 13, § 178(1).

15. See, e.g., *McPartlin v. Fransen*, 199 Mont. 143, 648 P.2d 729 (1982); *Brooks v. R. A. Clark's Garage, Inc.*, 117 N.H. 770, 378 A.2d 1144 (1977); *McNeil v. Brogan*, 201 Okla. 125, 202 P.2d 696 (1949).

The Restatement (Second) of Contracts notes that restitution is not generally available for performance rendered in exchange for an unenforceable promise. *RESTATEMENT*, *supra* note 13, § 197. Restitution may be allowed, however, when disproportionate forfeiture would otherwise result. *Id.* In addition, restitution may be awarded to a party who is excusably ignorant of facts or minor legislation that make the promise unenforceable, who is not equally in the wrong with the other party, or who withdraws from the transaction before the improper purpose has been achieved. Finally, restitution is also available when allowance of the claim would end a continuing situation that is contrary to the public interest. *Id.* §§ 198-99.

breaching party.¹⁶ Rather, denial of relief is viewed as a means of deterring conduct of which society has disapproved¹⁷ and preserving judicial integrity against the taint that would result if the courts were utilized to facilitate misconduct.¹⁸

These policies are relevant to the enforceability of a wide variety of contracts. At one end of the spectrum are those contracts that directly violate a statute, regulation, or public policy. To give a simple example, suppose a seller supplies a buyer with whiskey in a jurisdiction where the sale and purchase of alcoholic beverages is prohibited by statute. If the seller later seeks to recover the purchase price of the whiskey, the buyer may assert that the contract is unenforceable because it directly violates a statute.

At the other end of the spectrum are contracts that only facilitate violation of a statute, regulation, or public policy. To illustrate, suppose a seller supplies a buyer with whiskey in a jurisdiction where the sale and purchase of alcoholic beverages is legal. However, the seller knows that the buyer intends to resell the whiskey in a neighboring jurisdiction where the sale of alcoholic beverages is prohibited by statute. If the seller later seeks to recover the purchase price of the whiskey, the buyer may argue that the contract is unenforceable because he put the whiskey to a use that was prohibited by law.

Contracts such as this one, which provide the means to achieve an end contrary to statute, regulation, or public policy, may be characterized as "improper use contracts."¹⁹ The enforceability of improper use contracts is the first subject of this Article.

A. *Traditional Rules Governing Improper Use Contracts*

Over the years, the courts have developed a number of "traditional rules" governing the enforceability of improper use contracts. These rules apply when one contract party ("supplier") provides property, money, or services to another party ("customer"),²⁰ who then devotes the fruits of the contract to an improper use.²¹

16. As Lord Mansfield explained:

The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff, by accident, if I may so say . . . No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act . . . It is upon that ground the Court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff.

Holman v. Johnson, 1 Cowp. 343, 98 Eng. Rep. 1120, 1121 (1775); *accord Kaiser Steel*, 455 U.S. at 77 (citing *McMullen v. Hoffman*, 174 U.S. 639 (1899)).

17. See, e.g., *McMullen*, 174 U.S. at 669–70; *Takeuchi v. Schmuck*, 206 Cal. 782, 786–87, 276 P. 345, 346 (1929); RESTATEMENT, *supra* note 13, at introductory note to ch. 8 (unenforceability on grounds of public policy).

18. See, e.g., *Bank of the United States v. Owens*, 27 U.S. (2 Pet.) 527, 538–39 (1829); *Walters v. Fullwood*, 675 F. Supp. 155, 160 (S.D.N.Y. 1987) (quoting *Stone v. Freeman*, 298 N.Y. 268, 271, 82 N.E.2d 571, 572 (1948)); RESTATEMENT, *supra* note 13, at introductory note to ch. 8 (unenforceability on grounds of public policy).

19. This Article uses the term "improper use" because it is broad enough to encompass all uses that are contrary to public policy, including those which are not "illegal" in the sense of being subject to criminal penalty or sanction. The Restatement (Second) of Contracts also uses the term "improper use" in this context. RESTATEMENT, *supra* note 13, § 182.

20. The traditional rules apply only when the supplier performs his side of the bargain. See E. A. FARNSWORTH, *supra* note 13, § 5.6, at 356; RESTATEMENT, *supra* note 13, § 182 comment a.

21. The traditional rules govern only when the customer does in fact devote the property, money, or services to an

The traditional rules start from the premise that a supplier can enforce a contract made without knowledge that the customer plans to put the property, money, or services to an improper use.²² However, the rules go further: even if the supplier enters into the contract *knowing* that the customer intends to pursue an improper end, he can still enforce the contract in most jurisdictions.²³ Thus, in the illustration above, the seller will probably recover the price of the whiskey, even though he knew the buyer intended to resell it in violation of law.²⁴

There is, however, an exception to this majority rule. Knowledge of an improper use *will* prevent the supplier from enforcing the contract against the customer when the use involves serious moral turpitude,²⁵ or (in more modern terms) grave social harm.²⁶ To give a simple example, if a merchant sells a gun knowing that the buyer plans to commit a robbery, he will not be allowed to enforce the buyer's promise to pay the purchase price.²⁷

Corbin points out that "[j]ust how serious the crime or immorality must be in order that the [supplier's] mere knowledge will prevent his enforcement of the bargain is a matter of degree, such as to make it undesirable to attempt to draw an exact line."²⁸ The absence of any "exact line" leaves the courts free to decide which public policies are important enough to prevent enforcement of contracts.

The traditional rules draw a sharp distinction between mere knowledge of an improper use and active participation in the improper use. When a person not only knowingly supplies property, money, or services, but also takes further steps to assist the customer's improper use, he will not be permitted to enforce the contract.²⁹

improper use. See Annotation, *Seller's, Bailor's, Lessor's, or Lender's Knowledge of the Other Party's Intention to Put the Property or Money to an Illegal Use as Defense to Action for Purchase Price, Rent, or Loan*, 166 A.L.R. 1353, 1355 (1947) [hereinafter Annotation, *Lender's Knowledge*].

22. See, e.g., *Gold Bond Stamp Co. v. Bradfute Corp.*, 463 F.2d 1158, 1164 (2d Cir. 1972); *Lipault Co. v. Iowa Novelty Co.*, 204 N.W. 252, 253 (Iowa 1925); 6A A. CORBIN, *CORBIN ON CONTRACTS* § 1518, at 746 (1962). However, the customer, who makes the contract for the purpose of furthering his own improper use, may not enforce it against the supplier. *Id.* § 1518, at 744-45.

23. See, e.g., *Harbison v. Shirley*, 139 Iowa 605, 607, 117 N.W. 963, 964 (1908); *Carroll v. Beardon*, 142 Mont. 40, 43, 381 P.2d 295, 296 (1963); *San Benito Bank & Trust Co. v. Rio Grande Music Co.*, 686 S.W.2d 635, 638 (Tex. Ct. App. 1984); 6A A. CORBIN, *supra* note 22, § 1519, at 752; E. A. FARNSWORTH, *supra* note 13, § 5.6, at 357; 15 S. WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 1754, at 174 (3d ed. 1972); Annotation, *Lender's Knowledge*, *supra* note 21, at 1362; Annotation, *Enforceability of Contract Not in Itself Opposed to Law or Public Policy But Which Might Aid Incidentally in Evasion or Violation of the Law or Public Policy*, 53 A.L.R. 1364, 1366 (1928) [hereinafter Annotation, *Enforceability of Contract*].

A minority rule denies enforcement to the supplier who knows that the property, money, or services will be put to an improper use. See, e.g., *Mills Novelty Co. v. King*, 174 Ill. App. 559, 562-63 (1912); *Parker-Gordon Importing Co. v. Benakis*, 213 Iowa 136, 144, 238 N.W. 611, 614-15 (1931); E. A. FARNSWORTH, *supra* note 13, § 5.6, at 357; 15 S. WILLISTON, *supra*, § 1754, at 173; Annotation, *Enforceability of Contract*, *supra*, at 1372-73.

24. See, e.g., *Samuel Bowman Distilling Co. v. Nutt*, 34 Kan. 724, 10 P. 163 (1886); *Hill v. Spear*, 50 N.H. 253 (1870); Annotation, *Enforcing Foreign Contract, Valid Where Made, for Sale of Intoxicating Liquor*, 49 A.L.R. 1002, 1005 (1927) [hereinafter Annotation, *Sale of Intoxicating Liquor*].

25. See, e.g., *Hanauer v. Doane*, 79 U.S. (12 Wall.) 342, 346 (1870); *Milner, Wood & Wren v. Patton*, 49 Ala. 423, 426 (1873); 6A A. CORBIN, *supra* note 22, § 1519, at 752; E. A. FARNSWORTH, *supra* note 13, § 5.6, at 357; 15 S. WILLISTON, *supra* note 23, § 1754, at 174; Annotation, *Lender's Knowledge*, *supra* note 21, at 1357; Annotation, *Enforceability of Contract*, *supra* note 23, at 1375.

26. RESTATEMENT, *supra* note 13, § 182(b).

27. *Id.* at comment b, illustration 1.

28. 6A A. CORBIN, *supra* note 22, § 1519, at 752-53. See also Annotation, *Lender's Knowledge*, *supra* note 21, at 1357.

29. See, e.g., *Paul Jones & Co. v. Wilkins*, 135 Tenn. 146, 148, 185 S.W. 1074 (1916); *International Aircraft*

Returning to the whiskey illustration, if the seller had deliberately packed the whiskey in a manner that helped the buyer smuggle it into the neighboring jurisdiction, he would not be allowed to enforce the contract.³⁰

As hard as it may be to distinguish mere knowledge from participation,³¹ some courts draw an even more difficult distinction by granting enforcement when the supplier knows of the improper use but is indifferent to it, and denying enforcement when the supplier not only knows of the improper use, but also acts for the *purpose* of furthering it.³² Because the line between knowledge and purpose is very fine, this distinction invites a court or jury to achieve whichever outcome it desires through conclusory characterization of a supplier's mental state.³³

For simplicity's sake, this Article has illustrated the traditional rules with examples of improper uses that are banned outright: smuggling and robbery. It is important to realize, however, that the rules also apply when a use *could* be made in compliance with law but is not. Varying the facts of the whiskey illustration, suppose that the sale of alcoholic beverages had been legal in the neighboring jurisdiction, but the buyer had failed to obtain the license required by law. Under these facts, the buyer's use of the whiskey would not have been banned outright, but would nevertheless have been improper because the resale was conducted without a license. Thus, the enforceability of the contract would be called into question under the traditional rules. However, the rules probably would permit the seller to enforce the contract despite knowledge of the improper use, because selling liquor without a license is not serious misconduct.³⁴

Sales, Inc. v. Betancourt, 582 S.W.2d 632, 635 (Tex. Civ. App. 1979); *Dallas Brewery v. Holmes Bros.*, 51 Tex. Civ. App. 514, 516, 112 S.W. 122, 123 (1908); 15 S. WILLISTON, *supra* note 23, § 1755; Annotation, *Lender's Knowledge*, *supra* note 21, at 1386.

30. See, e.g., *Fisher v. Lord*, 63 N.H. 514, 3 A. 927 (1886); *Aiken v. Blaisdell*, 41 Vt. 655 (1869); Annotation, *Sale of Intoxicating Liquor*, *supra* note 24, at 1009.

31. See 15 S. WILLISTON, *supra* note 23, § 1756; Annotation, *Enforceability of Contract*, *supra* note 23, at 1380.

32. See, e.g., *Ashford v. Mace*, 103 Ark. 114, 118, 146 S.W. 474, 476 (1912) (dictum); *Hoefeld v. Ozello*, 290 Ill. 147, 149–50, 125 N.E. 5 (1919); *Graves v. Johnson*, 156 Mass. 211, 213–14, 30 N.E. 818, 819–20 (1892); Annotation, *Lender's Knowledge*, *supra* note 21, at 1401; Annotation, *Enforceability of Contract*, *supra* note 23, at 1380.

The Restatement (Second) of Contracts also appears to adopt this troublesome distinction between knowledge and purpose. Generally, once a supplier substantially performs, he is allowed to enforce the customer's promise despite knowledge of the improper use. RESTATEMENT, *supra* note 13, § 182 (1979). However, the supplier is not allowed to enforce the customer's promise when he acts for the purpose of furthering the improper use. *Id.* § 182(a). Such purpose may be found when the supplier commits additional acts in furtherance of the improper use. See *id.* at comment b, illustration 3 (seller who packs goods to facilitate smuggling cannot enforce buyer's promise to pay price). Such purpose may also be found when the supplier does no more than enter into the improper use contract. See *id.* at comment b, illustration 2 (lender who regularly makes loans to gamblers cannot enforce borrower's promise to repay loans).

33. Annotation, *Lender's Knowledge*, *supra* note 21, at 1410.

34. See, e.g., *Kreis v. Seligman*, 8 Barb. 439 (N.Y. App. Div. 1850); *Bonnie & Co. v. Blankenship*, 208 S.W. 934 (Tex. Civ. App. 1919); but see *Terre Haute Brewing Co. v. Hartman*, 19 Ind. App. 596, 49 N.E. 864 (1898).

The traditional rules have been applied in other cases in which property, money, or services were devoted to uses that could have been properly conducted, but were not. See, e.g., *McConnon v. Holden*, 35 Idaho 75, 204 P. 656 (1922) (peddler resold goods without a license); *Schaffer v. Federal Trust Co.*, 132 N.J. Eq. 235, 28 A.2d 75 (1942) (company used loan to finance activity conducted in violation of administrative regulation); *Blossom Farm Prod. Co. v. Kasson Cheese Co.*, 133 Wis.2d 386, 395 N.W.2d 619 (Wis. Ct. App. 1986) (manufacturer used cheese additive to produce imitation cheese that was marketed as real cheese).

B. Policy Foundations of the Traditional Rules

As is the case with all legal rules, the traditional rules governing the enforceability of improper use contracts must be founded upon underlying policy considerations. Unfortunately, few courts have identified the relevant policy considerations and still fewer have explained how or why the traditional rules further those policies. The lament of one author, issued more than fifty years ago, still rings true: "[N]one of the opinions, so far as the writer is aware, discusses the question [of the enforceability of an improper use contract] from the standpoint of the effectiveness of one result or another upon the policy considerations involved."³⁵ Thus, this Article must begin by identifying relevant policy considerations and speculating as to why the courts believe that the traditional rules best serve those policies. Whether the rules are in fact the best response to relevant policy concerns will be addressed in Part III of this Article.

Generally our legal system enforces contracts that are properly formed.³⁶ By assuring individuals that their expectations will be protected, enforcement encourages the formation of productive contracts that contribute to the general economic good.³⁷ Accordingly, any refusal to enforce properly formed contracts must be firmly grounded upon strong countervailing policy considerations.

Two policy considerations generally support refusal to enforce illegal contracts: preservation of judicial integrity and deterrence of misconduct.³⁸ Given the tendency of the traditional rules to favor enforcement, the courts may believe that refusal to enforce improper use contracts would not significantly further these two policies. For example, because the provision of property, money, or services to others is not inherently contrary to public policy, the courts may reason that their integrity is not affected when they lend their assistance to suppliers who have entered into improper use contracts. Similarly, the courts may believe that refusal to enforce improper use contracts would not significantly deter misconduct. Although refusal to enforce would discourage suppliers from providing property, money, and services to wrongdoers on credit, the courts may reason that wrongdoers would simply purchase the property and services³⁹ they need with cash or find some alternative means of achieving their improper ends. Some courts may even feel that refusal to enforce improper use contracts would *encourage* those who need property, money, or services to misbehave in order to render their contract obligations unenforceable.⁴⁰

The courts may also believe that enforcement of improper use contracts pro-

35. Gellhorn, *Contracts and Public Policy*, 35 COLUM. L. REV. 679, 690 (1935).

36. For a discussion of the law of contract formation, see 1, 1A A. CORBIN, *supra* note 22, and 1 S. WILLISTON, *supra* note 23.

37. E. A. FARNSWORTH, *supra* note 13, § 1.3 at 9.

Enforcement also supports the right of the individual to order his own affairs. See *id.* § 1.7 at 21. For further discussion of this important policy consideration, see *infra* text accompanying notes 42–56.

38. See *supra* text accompanying notes 17–18.

39. Of course, it makes no sense to suggest that wrongdoers would purchase the loans they need with cash. Thus, if the courts believe that refusal to enforce improper use loans would not deter borrower misconduct, they must be assuming that borrowers could finance their own improper activities. This assumption is criticized in Part III, *infra*.

40. See *Harbison v. Shirley*, 139 Iowa 605, 608, 117 N.W. 963, 964 (1908).

motes other important policy considerations. For example, one policy which generally supports enforcement of contracts challenged on public policy grounds is avoidance of forfeiture.⁴¹ The courts may consider enforcement of improper use contracts necessary to ensure that suppliers who provide property, money, or services to customers do not suffer forfeitures. In addition, the courts may feel that enforcement of improper use contracts is necessary to protect individual liberty and promote commerce. Because judicial opinions applying the traditional rules emphasize these last two policy considerations, this Article will examine them at some length.

1. *Individual Liberty*

In improper use cases, a recurrent theme is that a supplier has no responsibility to police a customer's use of property, money, or services.⁴² For example, in *Tyler v. Carlisle*,⁴³ a lender was allowed to enforce a loan despite knowledge that the proceeds of the loan would be used for gambling.⁴⁴ The *Tyler* court justified its decision as follows:

Any different doctrine would, in most instances, be impracticable and unjust. It does not follow that a lender has a guilty purpose merely because he knows or believes that the borrower has. There may be a visible line between the motives of the two. If it were not so, men would have great responsibilities for the motives and acts of others.⁴⁵

Another way of stating the same theme is illustrated by *Ashford v. Mace*,⁴⁶ which upheld the validity of a lease despite the lessor's knowledge that the lessee intended to use the premises as a brothel.⁴⁷ The *Ashford* court reasoned that "[t]he lessor is not the keeper of the conscience of the lessee, and has no police control over him in such matters"⁴⁸

A striking parallel may be found in the rules governing the accomplice liability of persons who supply property or services used in criminal activities. Under these rules, a supplier who knows that a customer plans to put property or services to a

41. See RESTATEMENT, *supra* note 13, § 178(2). The term "forfeiture" describes the loss that results when a contract party loses the right to the agreed exchange after he has performed. *Id.* at comment e.

42. See *Ashford v. Mace*, 103 Ark. 114, 118–19, 146 S.W. 474, 476 (1912); *Hoefeld v. Ozello*, 290 Ill. 147, 150, 125 N.E. 5, 6 (1919) (quoting *Ashford*, 103 Ark. at 118–19, 146 S.W. at 475–76); *Steele v. Curle*, 34 Ky. (4 Dana) 381, 388 (1836) (dictum); *Hubbard v. Moore*, 24 La. Ann. 591, 592 (1872); *Tyler v. Carlisle*, 79 Me. 210, 212, 9 A. 356, 357 (1887); *Michael v. Bacon*, 49 Mo. 474, 476 (1872); *Curran v. Downs*, 3 Mo. App. 468, 470–71 (1877) (dictum).

43. 79 Me. 210, 9 A. 356 (1887).

44. The *Tyler* court drew a distinction between knowledge and purpose, suggesting that enforcement would have been precluded had the loan been made for the purpose of facilitating the gambling. *Id.* at 212, 9 A. at 357. However, the court did not provide any guidance as to how the difficult distinction between knowledge and purpose could be drawn.

45. *Id.* at 212, 9 A. at 357.

46. 103 Ark. 114, 146 S.W. 474 (1912).

47. Like the *Tyler* court, the *Ashford* court adopted the troublesome distinction between knowledge and purpose, suggesting that the lease would be void if the lessor had intended that the premises be used for a bawdyhouse. *Id.* at 118, 146 S.W. at 476.

48. *Id.* at 118–19, 146 S.W. at 476.

criminal use is not liable as an accomplice⁴⁹ unless a serious crime is involved,⁵⁰ or he acts for the purpose of furthering the criminal use.⁵¹ Some have argued that suppliers are exonerated from accomplice liability because they are "entitled to carry on their lives without deviating every time doing so might . . . hamper the execution of a criminal plan."⁵²

These judicial and scholarly ruminations implicitly assume that suppliers play a *passive* role with respect to customer misconduct. One is reminded of the common law rule that A has no duty to rescue B, although he could do so with little inconvenience to himself.⁵³ As many scholars have noted, this "Bad Samaritan" doctrine⁵⁴ assumes that imposing responsibility for the welfare of others would unduly infringe upon individual liberty.⁵⁵ Under this view, any law that requires an individual to serve another "smacks of slavery or socialism."⁵⁶ Similarly, the courts seem to believe that suppliers have a liberty to enter into enforceable contracts without regard for the welfare of other individuals or society, and that holding suppliers responsible for customer misconduct would unduly infringe upon this liberty.

49. W. LAFAVE & A. SCOTT, *CRIMINAL LAW* § 64, at 508 (1972).

50. *Id.* § 64, at 509.

51. *See id.* § 64, at 506. In addition to intentionally aiding or facilitating criminal conduct, the accomplice must have the required mental state for the crime of which he is to be convicted. LaFave and Scott offer as an illustration the case in which A, knowing that B wishes to steal liquor from C's store, helps him break into the store and take the liquor, but then calls the police, all for the purpose of settling a score with B. Because A does not intend to permanently deprive C of his goods, A is not an accomplice to B's crimes of burglary and larceny. *Id.* at 506-07.

52. S. KADISH, S. SCHULHOFFER, & M. PAULSEN, *CRIMINAL LAW AND ITS PROCESSES* 623 (4th ed. 1983) (quoting G. FLETCHER, *RETHINKING CRIMINAL LAW* 676 (1978)).

Similarly, another author has argued against imposing accomplice liability upon suppliers who knowingly provide the means to criminal ends, reasoning that "[t]he seller of an ordinary marketable commodity is not his buyer's keeper in criminal law" G. WILLIAMS, *CRIMINAL LAW: THE GENERAL PART* § 124, at 373 (2d ed. 1961).

53. Because there is no duty to rescue under the common law, A's failure to save B will not subject A to liability in tort. *See* W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 56, at 375 (5th ed. 1984). Moreover, A's failure to save B will not subject A to criminal liability. *See* W. LAFAVE & A. SCOTT, *supra* note 49, § 26, at 183.

54. The New Testament parable of the Good Samaritan extolls the merits of a stranger who stopped to help a person who had been beaten, robbed, and left to die by the side of the road. *Luke* 10:30-37 (King James). Because the common law doctrine holds that there is no duty to rescue under these circumstances, many scholars have used the terms "Bad Samaritan" or "Bad Samaritanism" when writing about the doctrine. *See* D'Amato, *The "Bad Samaritan" Paradigm*, 70 NW. U.L. REV. 798 (1975); Rosenberg, *The Alternative of Reward and Praise: The Case Against a Duty to Rescue*, 19 COLUM. J.L. & SOC. PROBS. 1 (1985); Note, *Bad Samaritanism and the Duty to Render Aid: A Proposal*, 19 U. MICH. J.L. REF. 315 (1985) [hereinafter Note, *Bad Samaritanism*]; Note, *The Bad Samaritan: Rescue Reexamined*, 54 GEO. L.J. 629 (1966).

55. *See, e.g.,* Franklin, *Vermont Requires Rescue: A Comment*, 25 STAN. L. REV. 51 (1972); Hale, *Prima Facie Torts, Combination, and Non-Feasance*, 46 COLUM. L. REV. 196, 214 (1946); Linden, *Tort Liability for Criminal Nonfeasance*, 44 CAN. B. REV. 25, 29 (1966); Scheid, *Affirmative Duty to Act in Emergency Situations—The Return of the Good Samaritan*, 3 J. MARSHALL L. REV. 1, 4 (1969); Note, *Bad Samaritanism*, *supra* note 54, at 321; Note, *The Failure to Rescue: A Comparative Study*, 52 COLUM. L. REV. 631, 641 (1952) [hereinafter Note, *The Failure to Rescue*].

56. Linden, *supra* note 55, at 29; *see also* Hale, *supra* note 55, at 214; Scheid, *supra* note 55, at 4; Note, *The Failure to Rescue*, *supra* note 55, at 641.

2. *Promotion of Commerce*

Another recurrent theme in the early improper use cases is the desire to promote commerce.⁵⁷ Consider, for example, the early decision of *Hill v. Spear*.⁵⁸ There, a New York liquor dealer sold liquor to a New Hampshire saloon keeper. The sale, which was consummated in New York, was legal in that state. However, the dealer allegedly knew or had reason to know that the saloon keeper intended to resell the liquor in New Hampshire, in violation of New Hampshire law. Nevertheless, the *Hill* court held that the dealer could enforce his claim for the purchase price:

It is not spirituous liquors only, but innumerable kinds of merchandise, which *may* be applied to improper and unlawful uses. And it would be wholly impracticable, as well as unwise and unjust (because restraining to an unreasonable extent the trade and commerce of the country), to require the vendor of all sorts of merchantable goods to scrutinize the plans and purposes of the purchaser with regard to the use of the commodity, and to sell only at the peril of forfeiting the price in every case where a jury might find that the seller had reason to suppose the purchaser intended to make an improper or unlawful use of the article.⁵⁹

As this passage makes clear, the *Hill* court believed that denying enforcement when suppliers had reason to know of improper uses would have negative economic consequences. Moreover, the court apparently reasoned that denying enforcement when suppliers had knowledge of improper uses would also have negative economic consequences, for it allowed the liquor dealer to enforce the contract despite his alleged knowledge of the saloon keeper's improper use.⁶⁰ Other courts share this view, asserting commercial needs as a basis for allowing suppliers to enforce contracts despite their knowledge of improper uses.⁶¹ Commercial needs are believed to outweigh competing individual and societal concerns, except in cases in which suppliers have knowledge of serious improper uses.⁶²

Similar reasoning underlies the parallel rules governing criminal accomplice liability. One scholar has suggested that accomplice liability is not imposed upon suppliers who knowingly provide the means to criminal ends because legitimate trade

57. See *Steele v. Curle*, 34 Ky. (4 Dana.) 381, 388 (1836) (dictum); *Curran v. Downs*, 3 Mo. App. 468, 470 (1877) (dictum); *Hill v. Spear*, 50 N.H. 253, 275 (1870); *Tracy v. Talmage*, 14 N.Y. 162, 214 (1856); see also *Rose v. Mitchell*, 6 Colo. 102, 104 (1881) (refusal to enforce contract when vendor knew of intended improper use by remote vendee would unreasonably restrain commerce and trade).

Nineteenth-century America's preoccupation with commercial development, and the influence of this preoccupation upon the evolution of various legal doctrines, has been well documented. See generally L. FRIEDMAN, *A HISTORY OF AMERICAN LAW* (2d ed. 1985); M. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860* (1977). The expression of a desire to facilitate commerce in these early improper use cases strongly suggests that the traditional rules can be identified as yet another product of this general preoccupation.

58. 50 N.H. 253 (1870).

59. *Id.* at 275.

60. Perhaps the *Hill* court drew this conclusion because it believed that there was no meaningful distinction between knowledge and reason to know. See *id.* at 269; accord *Tracy*, 14 N.Y. at 214. Although courts and juries tend to blur the distinction between knowledge and reason to know, a meaningful distinction exists conceptually, and with care, can be drawn in practice. See *infra* Part III.

61. See *Steele*, 34 Ky. (4 Dana.) at 388 (dictum); *Curran*, 3 Mo. App. at 470 (dictum); see also *Rose*, 6 Colo. at 104 (allowing enforcement when vendor knew of improper use by remote vendee).

62. See *Steele v. Curle*, 34 Ky. (4 Dana.) 381, 387 (1836) (dictum); *Hill*, 50 N.H. at 277 (dictum); *Tracy v. Talmage*, 14 N.Y. 162, 215 (1856) (dictum).

would be inconvenienced if suppliers had to concern themselves with the affairs of their customers.⁶³

To the extent the traditional rules seek to promote commerce, they are reminiscent of yet another legal doctrine. Under the Uniform Commercial Code, a holder in due course⁶⁴ takes a negotiable instrument⁶⁵ free from all claims and most defenses.⁶⁶ In theory, the protection that the holder in due course doctrine affords against claims and defenses encourages a free market in negotiable paper, which in turn encourages merchants to accept negotiable paper in payment for various goods and services, rather than demanding immediate payment in cash.⁶⁷ However, the doctrine also causes some people to lose valid claims to negotiable instruments and forces others to pay instruments despite valid defenses to liability. Like the traditional rules, the holder in due course doctrine reflects the attitude that commercial needs outweigh competing individual and societal concerns.⁶⁸

In sum, the tendency of the traditional rules to favor enforcement of improper use contracts can be attributed to several possible judicial beliefs. The courts may feel that refusal to enforce improper use contracts would do little to preserve their integrity or deter misconduct. Moreover, the courts may wish to protect suppliers who provide property, money, or services to others against forfeiture. Finally, the courts may reason that enforcement of improper use contracts safeguards individual liberty and promotes commerce.

63. See G. WILLIAMS, *supra* note 52, at 369.

64. The Uniform Commercial Code defines a "holder in due course" as a holder who takes an instrument for value, in good faith, and without notice that the instrument is overdue or has been dishonored, or of any defense against or claim to the instrument on the part of any person. U.C.C. § 3-302(1) (1987). This definition incorporates several technical terms which are themselves further defined by the Code. See *id.* §§ 1-201(19), 1-201(20), 3-303, and 3-304.

65. In order for a writing to qualify as a negotiable instrument, it must:

(a) be signed by the maker or drawer; and (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and (c) be payable on demand or at a definite time; and (d) be payable to order or to bearer.

Id. § 3-104(1).

66. *Id.* § 3-305. The Code enumerates certain defenses that remain effective even against a holder in due course:

(a) infancy, to the extent that it is a defense to a simple contract; and (b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and (d) discharge in insolvency proceedings; and (e) any other discharge of which the holder has notice when he takes the instrument.

Id. § 3-305(2). In addition, the holder in due course takes the instrument subject to any defense of a party with whom he dealt. *Id.*

67. See J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 14-1, at 693-94 (3d ed. 1988); 4 W. HAWKLAND & L. LAWRENCE, *UNIFORM COMMERCIAL CODE SERIES* § 3-302:03, at 371 (1984); Benson & Squillante, *The Role of the Holder in Due Course Doctrine in Consumer Credit Transactions*, 26 *HASTINGS L.J.* 427, 428 (1974).

68. Of course, a holder in due course must take an instrument in good faith and without notice of any defense or claim to the instrument on the part of any person. See U.C.C. § 3-302(1) (1987). Thus, willingness to elevate commercial needs over competing concerns is more limited under the holder in due course doctrine than under the traditional rules, which permit suppliers to enforce contracts despite their knowledge of improper uses.

The point made here is simply that both the holder in due course doctrine and the traditional rules are perceived as necessary to promote commercial interests. Accordingly, both the holder in due course doctrine and the traditional rules are open to challenge to the extent that alternative doctrines or rules would respect commercial needs. See *infra* text accompanying notes 143-54.

II. ENFORCEMENT OF IMPROPER USE LOANS

Having reviewed the traditional rules and the policies that may support them, this Article must next examine the consequences of applying those rules to improper use loans.⁶⁹ The hypothetical that introduced this Article provides a useful framework for discussion.

As indicated above, improper uses include not only activities that are banned outright, but also legitimate activities that are conducted in violation of statutes, regulations, or public policy.⁷⁰ Thus, the hypothetical supposes the prospective borrower will use the loan proceeds to finance an activity which, though legitimate on its face, is conducted in violation of regulatory provisions—not an unrealistic assumption, given the sheer volume of modern business regulation.⁷¹

The hypothetical next supposes that, prior to making the loan, the lender has access to information indicating that the prospective borrower intends to use the loan proceeds to finance an activity conducted in violation of regulatory provisions. Such information could derive from the lender's customary preloan investigation of the borrower.⁷² Moreover, if the lender has been financing this particular borrower over an extended period of time, it could obtain such information by monitoring the borrower's operations during the lives of previous loans.⁷³

Finally, the hypothetical supposes that, despite this information, the lender makes the loan. Later, when the borrower defaults, the lender seeks judicial enforce-

69. A loan is put to an improper use, thereby calling into question its enforceability under the traditional rules, whenever it is used to further misconduct. Reported cases involve the use of loan proceeds to finance gambling, *see, e.g.*, *Estate of Henshaw*, 68 Cal. App. 2d 627, 157 P.2d 390 (1945); *Camas Prairie State Bank v. Newman*, 15 Idaho 719, 99 P. 833 (1909); *Kipp v. Welsh*, 141 Minn. 291, 170 N.W. 222 (1918); bribery, *see, e.g.*, *Hines v. Union Sav. Bank & Trust Co.*, 120 Ga. 711, 48 S.E. 120 (1904); *Rose v. Finley's Ex'r*, 250 Ky. 769, 63 S.W.2d 948 (1933); *Fears v. United Loan & Deposit Bank*, 172 Ky. 255, 189 S.W. 226 (1916); and other assorted misdeeds, *see Grand Valley Water Users' Ass'n v. Zumbunn*, 272 F. 943 (8th Cir. 1921) (ultra vires business conducted out of state); *Crocker Nat'l Bank v. Say*, 209 Cal. 436, 288 P. 69 (1930) (illegal purchase of bank stock); *Bank of Orland v. Harlan*, 188 Cal. 413, 206 P. 75 (1922) (falsification of bank records); *Peninsula Trust Co. v. Johnson*, 128 Md. 535, 97 A. 925 (1916) (illegal purchase of company's own stock).

70. *See supra* text accompanying note 34.

71. Loan proceeds may finance improper activities in a variety of ways. For example, a borrower may operate a business that has only one activity. If this activity is conducted in violation of law, then any loan that finances the business necessarily finances an improper activity.

Another borrower may operate a business that is composed of several identifiable projects. If one of these projects is conducted in violation of law, then any loan which finances only that project finances an improper activity. Conversely, if another of these projects is conducted in compliance with law, then any loan which finances only that project does not finance an improper activity, even though the borrower conducts other projects in violation of law. Finally, if some projects are conducted in compliance with law and others are not, any loan that finances the business as a whole necessarily finances both proper and improper activities.

72. Given the wide variety of loans that may be extended to borrowers, it is difficult to provide a general description of a "typical" preloan investigation. However, the investigation should include examination of the nature, history, and method of operation of the borrower's business. *See BANK CREDIT 4* (H. Prochnow ed. 1981). Thus, in most cases an ordinary preloan investigation will reveal whether the business is legitimate on its face. Additionally, in some cases the investigation will reveal whether the business is conducted in compliance with applicable regulatory provisions.

For a more thorough discussion of investigatory techniques that are appropriate to specific types of loans, *see BANK CREDIT, supra*, and *THE LOAN OFFICER'S HANDBOOK 185-218* (W. Korsvik & C. Meiburg eds. 1986).

73. It is common for a lender to monitor the borrower's operations during the life of a loan. *See THE LOAN OFFICER'S HANDBOOK, supra* note 72, at 187-88.

ment of the debt and a concomitant security interest in the borrower's property.⁷⁴ The borrower raises its regulatory violations as a defense to the lender's action.⁷⁵

Under these circumstances, will the court grant enforcement?

A. Analysis of the Hypothetical Under the Traditional Rules

Analysis of the hypothetical under the traditional rules begins with the proposition that a lender is permitted to enforce a loan made without knowledge that the borrower plans to put the proceeds to an improper use.⁷⁶ At first glance, this rule appears to offer little comfort to the hypothetical lender, which made the loan while in possession of information indicating that the proceeds would be used to finance an improper activity. The lender, however, might argue that this information gave it only *reason to know* of the improper activity, rather than actual knowledge.

While the Supreme Court has held that either knowledge or reason to know of a use involving serious moral turpitude will bar enforcement,⁷⁷ a few courts have distinguished knowledge from reason to know, holding that the latter is insufficient to preclude enforcement of an improper use contract.⁷⁸ However, to the extent there

74. A lender may sometimes vindicate its rights through self-help remedies rather than judicial enforcement. For example, if a loan is secured by personal property, the lender may repossess the collateral, dispose of it, and apply the proceeds to the outstanding obligation, all without ever seeing the inside of a courtroom. See U.C.C. §§ 9-503, 9-504 (1987).

Self-help remedies are not always available or effective, however. For example, the Uniform Commercial Code permits self-help repossession only when it can be accomplished without a breach of the peace. *Id.* § 9-503. Most case law interpreting § 9-503 holds that repossession in the face of the debtor's clear oral protest constitutes a breach of the peace. *J. WHITE & R. SUMMERS, supra* note 67, § 27-6, at 575-76. Thus, a borrower can easily frustrate a lender's attempts at self-help repossession. Even when collateral can be repossessed, its disposition does not always generate enough proceeds to make a lender whole.

Moreover, even though a lender pursues self-help remedies rather than judicial enforcement, it may still be subject to the traditional rules as demonstrated by *Schaffer v. Federal Trust Co.*, 132 N.J. Eq. 235, 28 A.2d 75 (1942). There, a lender which had taken a pledge of warehouse receipts as collateral for a loan sold the receipts and applied the proceeds to the outstanding debt of the insolvent borrower. The receiver for the borrower sued to recover the proceeds of the receipts, alleging that the lender had participated in unlawful conduct by knowingly financing a borrower which operated its business in violation of an obscure administrative regulation. Ultimately, the *Schaffer* court dismissed the allegation on the ground that the lender could not be charged with knowledge of the administrative regulation. However, the court did apply the traditional rules, thereby confirming that the rules can be used to challenge the exercise of self-help remedies. For further discussion of the *Schaffer* case, see *infra* text accompanying notes 89-91.

75. The borrower may be willing to assert this improper use defense because the civil or criminal penalties for the regulatory violations are small in comparison with the financial benefit to be obtained from avoiding enforcement of the loan, or the borrower may have little to lose by raising the defense because the authorities already know of the violations.

76. See, e.g., *Holtzman v. Israel*, 194 Ill. App. 474, 475 (1915); *Fears v. United Loan & Deposit Bank*, 172 Ky. 255, 264-65, 189 S.W. 226, 231 (1916); *Citizens Nat'l Bank v. Mitchell*, 24 Okla. 488, 522, 103 P. 720, 735 (1909). Moreover, a lender has no duty to inquire into the borrower's intended use of loan proceeds. See *Krake v. Alexander*, 86 Va. 206, 210, 9 S.E. 991, 992 (1889).

77. *Hanauer v. Doane*, 79 U.S. (12 Wall.) 342 (1870), was an action for the purchase price of supplies that the buyer had devoted to the use of the Confederate Army. The Supreme Court held that it was error to instruct the jury that the seller's knowledge of the improper use did not preclude recovery, reasoning as follows:

With whatever impunity a man may lend money or sell goods to another who he knows intends to devote them to a use that is only *malum prohibitum*, or of inferior criminality, he cannot do it, without turpitude, when he knows, or has every reason to believe, that such money or goods are to be used for the perpetration of a heinous crime, and that they were procured for that purpose.

Id. at 346 (emphasis added); see also *Hill v. Spear*, 50 N.H. 253, 269 (1870) (criticizing distinction between reason to know and actual knowledge as "thin and shadowy").

78. See, e.g., *Hotchkiss v. Finan*, 105 Mass. 86 (1870); *Ely v. Webster*, 102 Mass. 304, 307 (1869); *Adams v. Coulliard*, 102 Mass. 167, 172 (1869).

is a theoretical distinction between knowledge and reason to know in improper use case law, this distinction is not always maintained in practice. When the surrounding facts and circumstances would give a person reason to know of an improper use, the courts are often willing to infer actual knowledge of the use.

Consider, for example, the recent case of *Hendrix v. McKee*.⁷⁹ There, an electrical engineer was hired to design slot and "free play" machines, which his employer then manufactured and put to an improper use as gambling devices. Although the slot machines could have been used only for gambling, the "free play" machines, which returned free additional games or plays to the operator, could have been used for the legal purpose of amusement.⁸⁰

After his employment was terminated, the engineer sought damages for breach of an alleged employment contract. The *Hendrix* court reasoned that actual knowledge of the improper use could be inferred from the following facts: the engineer had spent his entire career designing gambling devices; he had been introduced to his employer by another manufacturer of gambling devices; he had been taken on a tour of his employer's gambling devices; he had received a large part of his salary in cash; and he had agreed not to compete with his employer in any business of a similar nature.⁸¹ Moreover, the engineer was charged with knowledge of any additional facts that a reasonable inquiry would have disclosed.⁸² Concluding that purpose to further the improper use could be inferred from the engineer's knowledge of that use,⁸³ the court refused to enforce the alleged employment contract.

In another modern case, *Blossom Farm Products Co. v. Kasson Cheese Co.*,⁸⁴ a seller sued a cheese manufacturer for the price of a yield-enhancing additive. The manufacturer had used the additive without labeling the end product as imitation cheese, as required by law. Because the manufacturer could not have survived economically if its end product had been sold as an imitation cheese at a correspondingly lower price, the court inferred that the seller had actually known of the improper labeling.⁸⁵ Despite this knowledge, the seller had repeatedly supplied the manufacturer with the additive. Noting that a course of dealing could evidence purpose to further an improper use,⁸⁶ the *Blossom* court refused to allow the seller to recover the price of the additive.⁸⁷

79. 281 Or. 123, 575 P.2d 134 (1978).

80. *Id.* at 131-32, 575 P.2d at 138-39.

81. *Id.* at 134-35, 575 P.2d at 140.

82. *Id.* at 134, 575 P.2d at 140.

83. *Id.*

84. 133 Wis. 2d 386, 395 N.W.2d 619 (Wis. Ct. App. 1986).

85. *Id.* at 394, 395 N.W.2d at 623.

86. *Id.* at 390, 395 N.W.2d at 621.

87. *Id.* at 395-96, 395 N.W.2d at 623. For further discussion of the *Blossom* case, see *infra* note 103.

Another case that demonstrates judicial readiness to infer actual knowledge of an improper use is *Youngs Rubber Corp. v. C.I. Lee & Co.*, 45 F.2d 103 (2d Cir. 1930). There, the plaintiff alleged that the defendants had infringed its trademark by selling condoms labeled with the word "Trojan." The defendants asserted that the plaintiff could not maintain suit under the Trade-Mark Act of 1905 because its trademark was used in unlawful business. They argued that, given the high volume of sales to retail druggists, the plaintiff must have known that the condoms were being resold to the public without prescriptions, in violation of law. *Id.* at 108-09. The *Youngs* court agreed that knowledge of illegal sales could be inferred. However, the court reasoned, mere knowledge of the improper use did not render the plaintiff's sales to the druggists illegal. Accordingly, the *Youngs* court held that the plaintiff could proceed with its suit. *Id.* at 110.

Suppose the hypothetical lender admits knowing that the borrower conducted its activity in a certain manner. Could it successfully argue that, due to unfamiliarity with the laws governing the borrower's business, it did not know that this manner of operation violated the law? The answer to this question is uncertain. On the one hand, the lender, like any other individual or entity, is presumed to know the law.⁸⁸ On the other hand, this presumption may not be consistently applied in every improper use case.

The case of *Schaffer v. Federal Trust Co.* illustrates this point.⁸⁹ In *Schaffer*, a lender financed a borrower which was in the business of purchasing and reselling warehouse receipts for whiskey. The lender took possession of the receipts as collateral for its loan. The borrower continued to sell the warehouse receipts in violation of an administrative regulation that required it to maintain possession of the receipts. When the borrower became insolvent, the lender sold the receipts in its possession and applied the proceeds to the debt.

The receiver for the insolvent company sued the lender to recover the proceeds of the warehouse receipts, alleging that the lender had participated in the borrower's unlawful conduct by knowingly financing that conduct. The *Schaffer* court dismissed this allegation for failure to state a cause of action, reasoning that the lender could not be charged with knowledge of the administrative regulation violated by the borrower.⁹⁰ Emphasizing the obscurity of the regulation, the court stated: "I suppose that among persons who are not engaged in buying or selling warehouse receipts, not one in a hundred has even heard of the regulation in question."⁹¹

Let us assume *arguendo* that *Schaffer* is rejected and the hypothetical lender is presumed to have known the law governing the borrower's business. Most jurisdictions allow enforcement of a loan made with *knowledge* that the borrower will devote the proceeds to an improper use.⁹² Thus, the odds are still good that the hypothetical lender will be allowed to enforce its loan and concomitant security interest against the borrower.

However, our analysis of the hypothetical is not yet complete. The traditional

88. See S. GARD, 1 JONES ON EVIDENCE § 3:16, at 161 (6th ed. 1972); Annotation, *Lender's Knowledge*, *supra* note 21, at 1356.

The presumption that every person knows the law has been justified on the pragmatic ground that successful administration of justice would be defeated if a person could plead ignorance of the law as a defense to legal obligations. S. GARD, *supra*, at 160.

89. 132 N.J. Eq. 235, 28 A.2d 75 (1942).

90. *Id.* at 239-40, 28 A.2d at 78-79. The court supported its holding on two alternative grounds. First, it reasoned that the lender had not participated in the borrower's unlawful conduct merely by lending money in the ordinary course of business. Second, even if there had been such participation, enforcement of the pledge would not be barred because violation of the administrative regulation did not involve serious moral turpitude. *Id.* at 241-42, 28 A.2d at 79-80.

91. *Id.* at 240, 28 A.2d at 79.

92. See, e.g., *Jackson v. City Nat'l Bank*, 125 Ind. 347, 350, 25 N.E. 430, 431 (1890); *San Benito Bank & Trust Co. v. Rio Grande Music Co.*, 686 S.W. 2d 635, 638 (Tex. Ct. App. 1984); Annotation, *Right to Recover Back Money Loaned for the Purpose of Being Used in an Illegal Transaction, or with Knowledge of Borrower's Intention So to Use It*, 1918C L.R.A. 247 [hereinafter Annotation, *Right to Recover Back Money*].

A minority rule denies enforcement of a loan made with knowledge of an improper use. See, e.g., *Camas Prairie State Bank v. Newman*, 15 Idaho 719, 724, 99 P. 833, 835 (1909) (dictum); *Catton v. Catton*, 69 Wash. 130, 133, 124 P. 387, 389 (1912).

rules present two further opportunities to challenge the enforceability of the loan and security interest.

1. Grave Social Harm

Enforcement of a loan will be denied when there is knowledge of an improper use involving serious moral turpitude or grave social harm.⁹³ Uses traditionally associated with serious moral turpitude or grave social harm include murder,⁹⁴ treason,⁹⁵ and robbery.⁹⁶ This list of egregious acts is not exclusive, however. "Serious moral turpitude" and "grave social harm" are flexible concepts that provide a court with the opportunity—and necessity—of ruling according to its own perceptions of the relative strengths of the public policies that may be offended by improper uses.⁹⁷ These judicial perceptions are likely to change over time, in a loose synchronization with the developing attitudes and beliefs of society as a whole. Treason constituted the serious moral turpitude of an earlier era; business activity conducted in significant violation of important statutes, regulations, or public policy may constitute the grave social harm of our own time.⁹⁸

The hypothetical is silent as to the nature and extent of the borrower's regulatory violations. To illustrate the grave social harm exception, assume the borrower disposed of toxic waste in a manner that violated an environmental protection statute, and that this violation inflicted or threatened to inflict severe personal injury and lasting environmental damage.⁹⁹ Under these circumstances, a court may very well hold that the borrower's improper activity involved grave social harm and deny enforcement of the loan or concomitant security interest.

93. Only a few cases have actually applied this exception to improper use loans. See, e.g., *Critcher v. Holloway*, 64 N.C. 526 (1870) (loan proceeds used to provide soldier for Confederate Army); *Smitherman v. Sanders*, 64 N.C. 522 (1870) (loan proceeds used to equip Confederate Army soldiers).

94. See *Hanauer v. Doane*, 79 U.S. (12 Wall.) 342, 347 (1870) (dictum); *Steele v. Curle*, 34 Ky. (4 Dana.) 381, 387 (1836) (dictum); *Tracy v. Talmage*, 14 N.Y. 162, 215 (1856) (dictum); E. A. FARNSWORTH, *supra* note 13, § 5.6 at 357.

95. See, e.g., *Hanauer*, 79 U.S. (12 Wall.) at 347; *Milner, Wood & Wren v. Patton*, 49 Ala. 423 (1873); *Tatum v. Kelley*, 25 Ark. 209 (1868); Annotation, *Lender's Knowledge*, *supra* note 21, at 1357-58.

96. See RESTATEMENT, *supra* note 13, § 182 comment b, illustration 1 (1979).

97. See *supra* text accompanying note 28.

98. Whether an activity conducted in violation of business regulations involves serious moral turpitude, or grave social harm, is a question seldom raised in reported improper use cases. The few decisions which address this question hold that violations of relatively minor statutes or regulations do not involve serious moral turpitude or grave social harm. See *Kansas City Hydraulic Press Brick Co. v. National Sur. Co.*, 167 F. 496, 505 (8th Cir. 1909) (violation of statute requiring competitive bidding); *Potomac Leasing Co. v. Vitality Centers, Inc.*, 290 Ark. 265, 269, 718 S.W.2d 928, 930 (1986) (violation of statute prohibiting use of telephone equipment to randomly dial numbers and solicit sales); *McConnon v. Holden*, 35 Idaho 75, 82, 204 P. 656, 657 (1922) (violation of statute requiring licensing of peddlers); see also *Tracy*, 14 N.Y. at 215 (ultra vires sale of stock).

99. No cases discuss whether an activity conducted in a manner that seriously threatens the welfare of individuals or society involves grave social harm. This writer believes that it does. For example, suppose a borrower operates a nuclear power plant in violation of regulations designed to prevent meltdown of the reactor core. Even if meltdown does not actually occur, the mere operation of the plant in violation of regulations that are critical to human safety involves grave social harm.

2. Participation and Purpose

Enforcement of an improper use loan will also be denied when a lender participates in the borrower's improper use¹⁰⁰ or shares the borrower's improper purpose.¹⁰¹ When will a court find such participation or purpose?

A few early cases hold that agreement to receive payment from the proceeds of an improper use constitutes sufficient participation to preclude recovery.¹⁰² Where such decisions are still good law, the hypothetical lender will be barred from enforcing the debt and security interest if it agreed to accept payment from the profits engendered by the improper activity.

Other authorities state that purpose to further an improper use may be evidenced by a course of dealing with persons engaged in improper conduct.¹⁰³ Thus, the hypothetical lender is more likely to lose the ability to enforce the loan and security interest if it financed the borrower's improper activity over a period of time.

Most disturbingly, a result-oriented court could, without anything more, simply recharacterize the hypothetical lender's knowledge of the improper activity as purpose in order to justify refusal to enforce the debt and security interest. As one writer has stated:

It is a logical rather than a practical distinction which separates the lender who has mere knowledge of the borrower's illegal purpose from one who lends for the illegal purpose without participating in it or making it a condition. Further, the subject is peculiarly one of those in which rules are likely to bend to the individual case; or, in other words, that leave too much to the judge or jury.¹⁰⁴

In sum, the court may refuse enforcement of the hypothetical loan and security interest if it concludes that the borrower's improper activity involved grave social

100. See, e.g., *Singleton v. Bank of Monticello*, 113 Ga. 527, 531-32, 38 S.E. 947, 948-49 (1901); *Johnstown Land Co. v. Brainerd Brewing Co.*, 142 Minn. 291, 294, 172 N.W. 211, 212 (1919); *Appleton v. Maxwell*, 10 N.M. 748, 760, 65 P. 158, 161 (1901); *Dodd v. Harper*, 670 S.W.2d 646, 650 (Tex. Ct. App. 1983).

101. See, e.g., *Bank of Orland v. Harlan*, 188 Cal. 413, 421-22, 206 P. 75, 78-79 (1922); *Tyler v. Carlisle*, 79 Me. 210, 212, 9 A. 356, 357 (1887) (dictum); *Fruchtman v. Klein*, 113 Misc. 522, 185 N.Y.S. 69 (N.Y. App. Term 1920); *Waugh v. Beck*, 114 Pa. 422, 428, 6 A. 923, 925 (1886); *Henderson v. Waggoner*, 70 Tenn. 133, 135 (1878); Annotation, *Right to Recover Back Money*, *supra* note 92, at 247.

102. See Annotation, *Lender's Knowledge*, *supra* note 21, at 1398-1400.

103. See *Blossom Farm Prod. Co. v. Kasson Cheese Co.*, 133 Wis. 2d 386, 390, 395 N.W.2d 619, 621 (Wis. Ct. App. 1986); RESTATEMENT, *supra* note 13, § 182 comment b.

In *Blossom*, a seller sued a cheese manufacturer for the price of a yield-enhancing additive. The manufacturer used the additive without labeling the end product as imitation cheese, as required by law. Despite its knowledge of this misconduct, the seller continued to supply the manufacturer with the additive. Noting that a course of dealing could evidence purpose to further an improper use, the *Blossom* court refused to allow the seller to recover the price of the additive. See *supra* text accompanying notes 84-87. The court emphasized that the course of dealing benefited not only the manufacturer, but also the seller, which grossed over \$5,000,000 as a result of the volume sales. *Blossom*, 133 Wis. 2d at 390 n.4, 395 N.W.2d at 621 n.4.

104. Annotation, *Right to Recover Back Money*, *supra* note 92, at 247.

Hendrix v. McKee, 281 Or. 123, 575 P.2d 134 (1978), provides a practical illustration of the ease with which the distinction between knowledge and purpose may be erased. Recall that in *Hendrix*, an engineer who designed devices used for gambling was denied enforcement of an alleged employment contract. See *supra* text accompanying notes 79-83. Because the engineer knew of the improper use, the *Hendrix* court reasoned that he intended to further the use. "Knowledge by the plaintiff of defendant's illegal gambling activities involving electro-mechanical or electronic devices affords the trial court a permissible, if not irresistible, inference of plaintiff's intent to aid such activities." *Id.* at 134, 575 P.2d at 140. Thus, the *Hendrix* court blithely assumed that knowledge was the functional equivalent of purpose.

harm or that the lender intended to further or participated in the borrower's activity. Given the subjectivity of determining what constitutes grave social harm and the ease with which the distinction between knowledge and purpose may be manipulated, the outcome of the hypothetical may ultimately depend upon what result the court wants to achieve.

III. SHOULD THE TRADITIONAL RULES BE CHANGED?

Thus far, this Article has examined the law governing improper use loans from a positive perspective, focusing on the nature of the traditional rules as they presently exist and their consequences for the enforceability of improper use loans. This positive analysis has revealed that, in most cases, present law does not hold lenders responsible for borrower misconduct.

But *Citicorp*, with its suggestion that lenders which provide the financial means to carry on a business *should* be held responsible for borrower misconduct, invites examination of the law governing improper use loans from a normative perspective as well. Should the law be changed to require the lender to act as the borrower's keeper?

To render its normative analysis more concrete, this Article will consider three alternatives to the traditional rule which permits the lender to enforce an improper use loan, even though it knows at the time the loan is made that the borrower intends to use the proceeds to finance an improper activity. The first alternative, or "knowledge rule," would simply reverse the current state of the law and bar the lender from enforcing an improper use loan made with actual knowledge that the borrower planned to use the proceeds to finance an improper activity. The second alternative, or "reason to know rule," would hold that the lender could not enforce an improper use loan if, from all the surrounding facts and circumstances (including those available upon reasonable inquiry), it had reason to know that the borrower intended to use the proceeds to finance an improper activity.¹⁰⁵ Finally, the third alternative, or "strict unenforceability rule," would bar the lender from enforcing any improper use loan, even if it did not know or have reason to know that the borrower intended to use the loan proceeds to finance an improper activity.¹⁰⁶ The benefits and costs associated with each alternative rule will be examined to determine whether adoption of any of the three rules is desirable.¹⁰⁷

105. The analysis that follows assumes that an institutional lender would have knowledge or reason to know of an improper activity only when the individual(s) charged with the responsibility of deciding whether to lend had knowledge or reason to know of the improper activity.

106. The three alternative rules would apply only when the borrower intended to engage in improper activity at the time the loan was made. Thus, the rules would not preclude enforcement simply because the borrower was unable to maintain regulatory compliance after the loan was made.

Of course, like the traditional rule, the alternative rules would apply only when the borrower did in fact engage in improper activity. See *supra* note 21.

107. As defined, the knowledge, reason to know, and strict unenforceability rules would apply only to improper use loans. This Article does not address the advisability of adopting similar rules to govern the enforceability of other improper use contracts (e.g., contracts for the sale of goods).

Nor does this Article address the desirability of adopting similar rules to govern accomplice liability under the

A. *Benefits of the Alternative Rules*

Our legal system favors the enforcement of properly formed contracts as a means of promoting the general economic good.¹⁰⁸ Accordingly, an alternative rule, which would prohibit the enforcement of some or all improper use loans, should be adopted only if this would produce compensating benefits. Two such benefits are preservation of judicial integrity and deterrence of borrower misconduct.

Because the lending of money is not inherently contrary to public policy, the courts may reason that their integrity is not affected when they enforce improper use loans.¹⁰⁹ However, this belief ignores the fact that lenders facilitate violations of public policy whenever they make improper use loans. The knowledge and reason to know rules would allow the courts to preserve their own integrity by refusing enforcement to lenders which knew or should have known that they were furthering borrower misconduct. The strict unenforceability rule would provide still greater protection by permitting the courts to withhold assistance whenever lenders facilitated borrower misconduct.

Nevertheless, it is difficult to conclude that preservation of judicial integrity alone justifies adoption of an alternative rule. So far, the courts have been willing to apply the traditional rule, even though it requires them to enforce most improper use loans. If the courts are willing to accept the threat that enforcement of improper use loans poses to their own integrity, there is little point in adopting an alternative rule solely for the purpose of reducing or eliminating that threat. Thus, it is important to consider whether the alternative rules would also serve to deter borrower misconduct.

Because some borrowers may be able to finance their own improper activities, the courts may feel that refusal to enforce improper use loans would not significantly deter borrower misconduct.¹¹⁰ However, this view ignores the fact that most borrowers cannot operate without outside financial assistance. An alternative rule which precluded enforcement of improper use loans would help to deter activities that were banned outright, either by drying up sources of financing altogether or by making financing more expensive. Moreover, such a rule would also encourage borrowers engaged in legitimate activities to cure their regulatory violations by making financing unavailable or more expensive if they failed to do so.

Consider first the knowledge rule, which would deny judicial enforcement to lenders which knowingly funded improper activities. This rule would eliminate sources of financing by causing lenders to refuse loans to borrowers known to be engaged in improper activities. Alternatively, this rule would render financing more expensive by causing lenders to charge borrowers known to be engaged in improper activities higher interest rates to cover projected losses on unenforceable loans.

Some might argue that the knowledge rule would have little deterrent effect,

criminal law. The different policy objectives of contract law and criminal law, and the distinction between civil forfeiture and criminal penalty, make it impossible to assume that conclusions which are valid within one discipline are equally sound within the other.

108. See *supra* text accompanying notes 36–37.

109. See *supra* text accompanying note 38.

110. See *supra* text accompanying note 39.

reasoning that lenders would simply restrict the scope of their ordinary preloan investigations to avoid learning of borrower misconduct that might jeopardize the enforceability of their loans. However, such an argument ignores the fact that lenders have an incentive to thoroughly investigate prospective borrowers to ensure that they are likely to repay their loans. Moreover, individuals charged with the responsibility of extending loans have an incentive to adequately investigate the solvency and responsibility of prospective borrowers because failure to do so may subject them to personal liability for resulting losses.¹¹¹ It seems unlikely, therefore, that lenders would limit their ordinary preloan investigations to avoid learning of borrower misconduct.

Consider next the reason to know and strict unenforceability rules. The reason to know rule would deny judicial enforcement to lenders which should have known that they were funding improper activities, and the strict unenforceability rule would deny judicial enforcement to lenders which funded improper activities. Under these rules, lenders would deny loans or charge higher interest rates to cover projected losses on unenforceable loans not only to borrowers known to be engaged in improper activities, but also to borrowers *suspected* to be engaged in improper activities. Thus, the reason to know and strict unenforceability rules would have a greater deterrent effect than the knowledge rule.

The reason to know and the strict unenforceability rules would also make it difficult for lenders to predict the enforceability of proposed loans. Under the reason to know rule, lenders could not be certain which facts or circumstances would trigger a finding that they should have known borrowers were engaged in improper activities. Under the strict unenforceability rule, lenders could not be certain which borrowers were engaged in improper activities. As a result, lenders would expand their ordinary preloan investigations to include closer examination of the borrower activities until the cost of obtaining additional information equalled the reduction in the cost of unenforceable debt. As the expanded investigations revealed more improper activities than were already known or suspected, lenders would deny loans or charge higher interest rates to more borrowers, and the reason to know and strict unenforceability rules would have a still greater deterrent effect than the knowledge rule.¹¹²

This superior deterrent effect would be particularly evident in cases in which borrowers conducted legitimate activities in violation of regulatory provisions. Ordinary preloan investigations would reveal whether borrower activities were facially legitimate, but would not always reveal the presence of regulatory violations.¹¹³ Under the knowledge rule, lenders would have no incentive to expand ordinary preloan investigations in an attempt to detect such violations. Instead, they would

111. 1 MICHIE ON BANKS AND BANKING ch. 3, § 55 (1986).

112. Although one can confidently predict that both the reason to know and strict unenforceability rules would deter borrower misconduct, it is difficult to predict the extent to which one rule would be more effective than the other. One safe generalization is that more improper use loans would be unenforceable under the strict unenforceability rule than under the reason to know rule. This suggests that additional investigation might be cost-effective under the strict unenforceability rule more often than under the reason to know rule, causing the strict unenforceability rule to have a greater deterrent effect.

113. See *supra* note 72.

simply continue to extend loans at favorable rates to borrowers committing undiscovered regulatory violations. In contrast, under the reason to know and strict unenforceability rules, lenders would expand their ordinary preloan investigations to include thorough examination of regulatory compliance until the cost of obtaining additional information equalled the reduction in the cost of unenforceable debt. As the expanded investigations revealed more regulatory violations than were already known or suspected, lenders more often would refuse loans or charge higher interest rates and more borrowers would be encouraged to cure their regulatory violations.

Two possible challenges to the foregoing analysis must be addressed here. First, some might question the starting assumption that refusing to allow lenders to enforce improper use loans would be the most effective means of deterring borrower misconduct. In *Bateman Eichler, Hill Richards, Inc. v. Berner*,¹¹⁴ investors brought a private damages action for violation of federal securities laws against a broker and a corporate insider who had induced them to purchase stock by divulging false and materially incomplete information on the pretext that the inside information was accurate. Pointing out that trading on inside information was itself a violation of federal securities laws, the defendants asserted that the action should be dismissed on the ground that it was barred by the common law doctrine of *in pari delicto*—of equal fault.

The Supreme Court held that the *in pari delicto* doctrine did not require dismissal of the action. The doctrine presumed, the Court noted, that denying judicial relief to wrongdoers would effectively deter illegal conduct.¹¹⁵ The Court reasoned, however, that barring private actions in these circumstances would permit a number of fraudulent practices to go undetected and unremedied.¹¹⁶ The public interest would be most frequently advanced, the Court concluded, if defrauded investors were permitted to bring suit and expose illegal practices to full public view for imposition of appropriate sanctions.¹¹⁷

This reasoning, though powerful within its own context, is not persuasive within the different context addressed in this Article. Permitting lenders to enforce loans that borrowers expected to repay in any event would not deter borrowers from engaging in improper activities. Moreover, allowing lenders to enforce improper use loans would not serve to bring borrower misconduct to the attention of appropriate authorities; lenders could sue to enforce loans without having to allege or prove that the

114. 472 U.S. 299 (1985).

115. *Id.* at 306.

116. *Id.* at 315.

117. *Id.* at 319. As an additional ground for its decision that the action should not be dismissed, the Supreme Court reasoned that investors who traded on false inside information were not *in pari delicto* with brokers and insiders who committed a potentially broader range of securities violations by disclosing false inside information. *Id.* at 312–14.

The *Bateman Eichler* decision is supported by the Court's earlier opinion in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). There, dealers who operated "Midas Muffler Shops" brought a private damages action against Midas, Inc., and related parties, alleging that the franchise agreement created a conspiracy to restrain competition in violation of federal antitrust laws. The defendants argued that the *in pari delicto* doctrine barred the action, noting that the dealers had voluntarily entered into the franchise agreement despite their knowledge of anticompetitive provisions. *Id.* at 135–36. The Court held that the *in pari delicto* doctrine did not bar the action, reasoning that the threat of private action was needed to deter violations of the antitrust laws. *Id.* at 138–40.

proceeds had been used to finance improper activities. If anything, it seems more likely that refusal to enforce improper use loans would cause borrowers to expose their own misconduct to public view, at least to the extent that the financial benefits of avoiding enforcement outweighed potential civil or criminal penalties.

The second possible challenge to the analysis set forth above is that the alternative rules might *encourage* rather than deter borrower misconduct.¹¹⁸ Under this view, borrowers would deliberately misbehave in order to render their loans unenforceable. However, few borrowers would be willing to switch from legitimate to criminal activities solely for the purpose of obtaining “free” financing. Furthermore, although some borrowers might be willing to conduct legitimate activities in violation of regulatory provisions, the knowledge and reason to know rules would not provide them with any incentive to do so. If borrowers openly violated regulatory provisions, lenders would simply refuse to lend or charge higher interest rates, and if borrowers secretly violated regulatory provisions, their loans would remain enforceable because lenders would not know or have reason to know of their misconduct.

It is possible that the strict unenforceability rule would encourage some borrowers to secretly violate regulatory provisions in the hope that lenders would unwittingly extend loans that could not be enforced. However, borrowers would be discouraged from deliberately violating regulatory provisions to the extent that potential civil or criminal penalties outweighed the financial benefits of obtaining unenforceable loans.

B. *Costs of the Alternative Rules*

Although it appears that all three alternative rules would produce certain benefits, they also have the potential to impose additional costs. This Article will focus primarily on costs to individual liberty and commerce. Whether the alternative rules would cause lenders to suffer forfeitures will be addressed within the analysis of commercial costs.

1. *Individual Liberty*

As discussed above, the courts apparently believe that suppliers enjoy a liberty to enter into enforceable contracts without regard for the welfare of other individuals or society and that holding suppliers responsible for customer misconduct would unduly infringe upon this liberty.¹¹⁹ The traditional rule, which permits lenders to enforce loans despite their knowledge that borrowers will misuse the loan proceeds, is an outgrowth of this belief.

However, the courts are incorrect for two reasons. First, many modern lenders are not individual human beings, but rather fictitious legal entities such as corporations. An entity which exists solely by the grace of the state and has no natural

118. See *supra* text accompanying note 40.

119. See *supra* text accompanying notes 42–56.

rights¹²⁰ does not have as much claim to lead its own life without regard for others as does an individual possessed of natural rights.

Second, and more fundamentally, the courts wrongly assume lenders which make improper use loans are simply "Bad Samaritans" which fail to rescue individuals and society from the consequences of borrower misconduct. Rather, lenders which make improper use loans actively further borrower violations of public policy that harm individuals and society.

Our legal culture has long drawn a fundamental distinction between the freedom not to confer benefits upon others and the freedom to harm others:

[W]hen a government *requires* a person to act, it is necessarily interfering more seriously with his liberty than when it places limits on his freedom to act—to make a man serve another is to make him a slave, while to forbid him to commit affirmative wrongs is to leave him still essentially a free man.¹²¹

Embracing this distinction, Epstein argues that the Bad Samaritan doctrine, which addresses and safeguards the freedom not to confer benefits upon others, reflects the importance of individual liberty. Acceptance of the Bad Samaritan doctrine, despite its potentially fatal consequences for persons in need of rescue, is an unavoidable cost of freedom.¹²² In contrast, Epstein argues that a *prima facie* case for tort liability is made out when one person causes harm to another.¹²³ In his view, neither intent to harm nor negligence is an essential element of the *prima facie* case.¹²⁴ Strict liability may be imposed without offending individual liberty, for liberty does not include the freedom to cause harm to others.¹²⁵

Reasoning by analogy, Epstein's theory of strict liability suggests that liberty

120. See 6 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 2476 (rev. perm. ed. 1989); 1 MICHE ON BANKS AND BANKING, *supra* note 111, ch. 2, § 1.

121. Hale, *supra* note 55, at 214. With this passage, Hale describes a certain attitude in the law, without endorsing its worth as a normative judgment.

Prosser and Keeton make much the same point in explaining why the common law had no difficulty imposing tort liability for active misconduct working positive injury to others, or misfeasance, but was loathe to impose any liability for passive inaction, or nonfeasance:

The highly individualistic philosophy of the older common law had no great difficulty in working out restraints upon the commission of affirmative acts of harm, but shrank from converting the courts into an agency for forcing men to help one another.

W. PROSSER & W. KEETON, *supra* note 53, § 56, at 373 (citation omitted).

122. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 198 (1973).

Many other scholars have urged recognition of a duty to rescue, arguing that the interest in preserving life and health outweighs the interest in maintaining individual freedom. See, e.g., Scheid, *supra* note 55; Note, *Bad Samaritanism*, *supra* note 54, at 335; Note, *Stalking the Good Samaritan: Communists, Capitalists and the Duty to Rescue*, 1976 UTAH L.R. 529, 542; Note, *The Failure to Rescue*, *supra* note 55, at 646. To date, however, such arguments have not generated corresponding changes in the Bad Samaritan doctrine. Only a few legislatures have enacted statutes imposing a general duty to rescue. See MINN. STAT. ANN. § 604.05(1) (West 1988); VT. STAT. ANN. tit. 12, § 519(a) (1973); see also MASS. ANN. LAWS ch. 268, § 40 (Law. Co-op. Supp. 1989) (imposing duty to report certain crimes to authorities); R.I. GEN. LAWS § 11-37-3.1 (Supp. 1988) (imposing duty to report sexual assaults to authorities). Moreover, most courts remain unwilling to impose a duty to rescue unless there is a special relationship between the potential rescuer and victim. See W. PROSSER & W. KEETON, *supra* note 53, § 56, at 376. In the context of tort liability, relationships that have provided a foundation for judicial recognition of a duty to rescue include carrier-passenger, employer-employee, and host-social guest. See *id.* In the context of criminal liability, relationships that have been found to create a duty to assist include parent-child and husband-wife. See W. LAFAVE & A. SCOTT, *supra* note 49, § 26, at 184.

123. Epstein, *supra* note 122, at 189.

124. See *id.* at 169, 173, 176, 186.

125. *Id.* at 203-04.

does not include the freedom to make enforceable improper use loans that lead to violations of public policy. Under this view, lenders would not suffer a loss of liberty if the enforceability of improper use loans was restricted under the knowledge or reason to know rules, or denied altogether under the strict unenforceability rule.

However, Epstein's theory of strict liability diverges substantially from case law, which imposes tort liability only when the defendant knows or should know that his act imposes an unaccepted risk on others.¹²⁶ Oliver Wendell Holmes takes a different view of liberty which is consistent with case law:

Nay, why need the defendant have acted at all, and why is it not enough that his existence has been at the expense of the plaintiff? The requirement of an act is the requirement that the defendant should have made a choice. But the only possible purpose of introducing this moral element is to make the power of avoiding the evil complained of a condition of liability. There is no such power where the evil cannot be foreseen.

. . . .

. . . The undertaking to redistribute losses simply on the ground that they resulted from the defendant's act would not only be open to these objections, but, as it is hoped the preceding discussion has shown, to the still graver one of offending the sense of justice. Unless my act is of a nature to threaten others, unless under the circumstances a prudent man would have foreseen the possibility of harm, it is no more justifiable to make me indemnify my neighbor against the consequences, than to make me do the same thing if I had fallen upon him in a fit, or to compel me to insure him against lightning.¹²⁷

In other words, Holmes believes that limiting tort liability to cases in which the defendant knows or should know that his conduct creates a risk of injury reconciles the reasonable freedom of the defendant with the protection of the plaintiff from injury.¹²⁸ Reasoning by analogy, this theory of tort liability suggests that lenders have the freedom to make enforceable loans so long as they do not know or have reason to know that they are furthering violations of public policy. Under this view, lenders would not suffer a loss of liberty if the enforceability of improper use loans was restricted under the knowledge or reason to know rules.¹²⁹ However, the strict unenforceability rule would infringe upon the freedom of lenders to make enforceable loans when they did not know or have reason to know that they were furthering violations of public policy.¹³⁰

In addition to these analogies from the field of torts, an interesting parallel can

126. See Wright, *Causation in Tort Law*, 73 CALIF. L.R. 1735, 1757 (1985).

127. O.W. HOLMES, *THE COMMON LAW* 77-78 (M. Howe ed. 1963) (citation omitted).

128. See *id.* at 115.

129. However, adoption of the knowledge or reason to know rule might infringe upon the liberty of some borrowers. To illustrate, suppose a borrower applies for a loan, intending to use the proceeds to gamble in violation of statute. One could argue that the statute infringes upon the borrower's liberty by prohibiting him from engaging in the self-regarding activity of gambling. See J. MILL, *ON LIBERTY* 168-69 (Penguin ed. 1988) (1859). It then follows that adoption of the knowledge or reason to know rule would infringe upon the borrower's liberty by making financing for gambling more difficult or expensive to obtain. See *id.* at 165.

130. Some might worry that the reason to know and strict unenforceability rules would infringe upon liberty by discouraging cautious lenders from financing activities that did not violate public policy. See *infra* text accompanying note 138. Lenders could eliminate this unwelcome cost by expanding ordinary preloan investigations to include closer examination of borrower activities. Of course, expanded investigations could impose their own unwelcome costs by increasing the price of financing for proper activities. See *infra* text accompanying notes 139-40.

be drawn from the field of criminal law. An early draft of the Model Penal Code included the following provision establishing criminal accomplice liability: "A person is an accomplice of another person in commission of a crime if . . . acting with knowledge that such other person was committing or had the purpose of committing the crime, he knowingly, substantially facilitated its commission" ¹³¹

Accompanying comments suggested that the draft provision restricted the liberty of suppliers to provide goods or services to customers in an effort to prevent crime:

[W]hen the only interest of the actor is his wish for freedom to forego concern about the criminal purposes of others, though he knowingly facilitates in a substantial measure the achievement of such purposes, it is an interest that, we think, is properly subordinated generally to the larger interest of preventing crime. ¹³²

Ultimately, this draft provision was not incorporated in the official draft of the Model Penal Code. ¹³³ The American Law Institute reasoned that the general provision governing criminal accomplice liability should be more narrowly formulated to avoid imposing liability when it was inappropriate. ¹³⁴ Nevertheless, this drafting history indicates that at least some criminal law scholars believe that liberty does not include the freedom to knowingly facilitate crimes. This attitude lends further support to the conclusion that lenders do not have the freedom to make enforceable loans when they know that they are furthering violations of public policy.

2. *Promotion of Commerce*

As also discussed above, the courts believe that it would burden commerce to hold suppliers responsible for customer misconduct. ¹³⁵ The traditional rule, which permits lenders to enforce loans despite their knowledge that borrowers will misuse the loan proceeds, is a product of this belief.

Unfortunately, the courts have not adequately explained why a different rule would impose unreasonable costs upon commerce or what those costs might be. ¹³⁶ To fill the gap, this Article will analyze the extent to which the knowledge, reason to

131. MODEL PENAL CODE § 2.04(3)(b) (Tentative Draft No. 1, 1953).

132. *Id.* § 2.04 comments, at 32.

133. See MODEL PENAL CODE AND COMMENTARIES § 2.06 (1985).

134. *Id.* § 2.06, comment at 318. The official draft of the Model Penal Code left open the possibility that a broader accomplice liability could apply to individual substantive offenses by providing: "A person is an accomplice of another person in the commission of an offense if . . . his conduct is expressly declared by law to establish his complicity." *Id.* § 2.06(3)(b).

Similarly, a few jurisdictions have enacted statutes which provide that a person who knowingly supplies the means to commit certain crimes is guilty of criminal facilitation. See KY. REV. STAT. ANN. §§ 506.080-.100 (Michie/Bobbs-Merrill 1985); N.Y. PENAL LAW §§ 115.00-.15 (McKinney 1987); N.D. CENT. CODE § 12.1-06-02 (1985).

135. See *supra* text accompanying notes 57-68.

136. Some courts assert that, if knowledge or reason to know of an improper use precluded enforcement, merchants would have to scrutinize the purposes of their contract partners. See *Hill v. Spear*, 50 N.H. 253, 276 (1870); *Tracy v. Talmage*, 14 N.Y. 162, 214 (1856). Another court suggests that refusal to enforce when there was knowledge of an improper use would slow the pace of commerce by requiring merchants to control the use of products sold. *Curran v. Downs*, 3 Mo. App. 468, 470 (1877) (dictum). Yet another court simply states that making a seller responsible for the known motives of his buyer would be inappropriate in a commercial, busy, and enterprising age. *Steele v. Curle*, 34 Ky. (4 Dana.) 381, 388 (1836) (dictum); see also *Rose v. Mitchell*, 6 Colo. 102, 104 (1881) (refusal to enforce contract when vendor knew of improper use by remote vendee would restrain commerce).

know, and strict unenforceability rules would impose costs upon commerce. As an integral part of its analysis, this Article will examine the extent to which the alternative rules would cause lenders to suffer forfeitures.

Analysis must begin with an identification of undesirable costs that the alternative rules might impose upon commerce. As explained above, all three rules would impose costs upon *improper* borrower activities by making financing harder to get and more expensive. However, these costs would be desirable because they would help to deter borrower misconduct. The real question is whether the alternative rules would impose undesirable costs upon *proper* borrower activities—that is, activities which were facially legitimate and conducted in compliance with pertinent regulatory provisions—by making financing harder to get and more expensive.

The knowledge rule would deny enforcement to lenders which knowingly funded improper activities. Because lenders would be able to recognize whether they had actual knowledge of improper activities, they would also be able to determine the enforceability of proposed loans with a fair degree of accuracy. If lenders simply refused to make loans to borrowers known to be engaged in improper activities, they would not suffer forfeitures and would have no losses to be passed through to other borrowers in the form of higher interest rates. Alternatively, if lenders made loans to borrowers known to be engaged in improper activities, but charged higher interest rates to cover projected losses on unenforceable loans, any forfeitures suffered would be relieved without the need to pass losses through to other borrowers. Either way, the knowledge rule would not significantly increase the cost of financing for proper activities.

Moreover, the knowledge rule should not significantly reduce the availability of financing for proper activities. Because lenders would be able to determine the enforceability of proposed loans with relative ease, they would not be discouraged from funding proper activities.¹³⁷

The foregoing analysis assumes that the knowledge rule would be strictly construed so that only solid evidence of actual knowledge would suffice to render loans unenforceable. If the rule was loosely construed, so that knowledge could be readily inferred from surrounding facts and circumstances, it would approximate the reason to know rule. Further, as the following analysis makes clear, both the reason to know and the strict unenforceability rules would have a significantly greater impact upon the availability and cost of financing for proper activities than the knowledge rule.

The reason to know rule would deny judicial enforcement to lenders which should have known that they were funding improper activities, and the strict unenforceability rule would deny judicial enforcement to lenders which funded improper

137. There is one context in which application of the knowledge rule could affect the cost and availability of financing for proper activities.

Suppose that a borrower operated a business composed of several identifiable projects. If some of these projects were conducted in compliance with law and others were not, any loan that financed the business as a whole would necessarily finance both proper and improper activities. If the knowledge rule applied, a lender which knew of the improperly conducted projects would either refuse to finance the business or charge the borrower a higher interest rate. Thus, the borrower would find that the financing necessary to support its properly conducted projects was more difficult to obtain or more expensive.

activities. Under these rules, lenders would deny loans or charge higher interest rates not only to borrowers known to be engaged in improper activities, but also to borrowers *suspected* to be engaged in improper activities. Unfortunately, in at least some of these cases, further investigation would have revealed that the proposed activities were entirely proper. Thus, financing for some proper activities would become less available and more expensive.¹³⁸

The reason to know and the strict unenforceability rules would also make it difficult for lenders to predict the enforceability of proposed loans. Under the reason to know rule, lenders could not be certain which facts or circumstances would trigger a finding that they should have known borrowers were engaged in improper activities. Under the strict unenforceability rule, lenders could not be certain which borrowers were engaged in improper activities. As a result, lenders would expand their ordinary preloan investigations to include closer examination of borrower activities¹³⁹ until the cost of obtaining additional information equalled the reduction in the cost of unenforceable debt. Lenders would seek to pass the additional cost of their expanded investigations through to all borrowers, thereby increasing the cost of financing for proper activities.¹⁴⁰ Moreover, once the cost of obtaining additional information equalled the reduction in the cost of unenforceable debt, lenders would stop expanding their ordinary preloan investigations. Lacking complete information, they would make some loans that would later prove to be unenforceable. Lenders would either forfeit the amount of these loans or pass their losses through to all borrowers, thereby increasing the cost of financing for proper activities still further.¹⁴¹

The reason to know and strict unenforceability rules would impose these costs primarily as a result of their application to cases in which borrowers conducted legitimate activities in violation of regulatory provisions. Ordinary preloan investigations would reveal whether borrower activities were facially legitimate, but would not always disclose the presence of regulatory violations.¹⁴² To the extent lenders

138. Perhaps these borrowers could convince lenders to give them loans at the usual interest rates by coming forward with information proving that their activities were proper. However, this effort would reduce, not eliminate, the costs imposed upon proper activities.

139. Unless lenders could identify in advance those borrowers which were most likely to use loan proceeds to finance improper activities (a difficult task given the wide range of borrower conduct which might violate public policy), their expanded investigations would have to include all borrowers as a matter of course.

140. Perhaps it would be cheaper for borrowers to take the initiative, and provide lenders with information establishing that their activities were proper. Although this course of action might help to minimize costs, it would not eliminate them entirely. Unless lenders were able to determine in advance which borrowers were most likely to use loan proceeds to finance improper activities, all borrowers, including those seeking financing for proper activities, would be forced to incur the cost of educating lenders as to the legitimacy and regulatory compliance of their activities.

141. Although one can confidently predict that both the reason to know and strict unenforceability rules would increase the cost of financing for proper activities, it is difficult to predict the extent to which one rule would have a greater impact than the other. One safe generalization is that more loans would be unenforceable under the strict unenforceability rule than under the reason to know rule. This suggests that additional investigation might be cost-effective under the strict unenforceability rule more often than under the reason to know rule. *See supra* note 112. If so, then lenders would incur greater investigation costs, which, when passed through to borrowers, would produce a greater increase in the cost of financing for proper activities. Moreover, to the extent additional investigation was not cost-effective, lenders might extend more unenforceable loans under the strict unenforceability rule than under the reason to know rule. If so, then lenders would suffer forfeitures or pass losses through to borrowers more often, causing a greater increase in the cost of financing for proper activities.

142. *See supra* note 72.

expanded preloan investigations to include closer examination of regulatory compliance, they would incur additional costs that would be passed through to all borrowers. To the extent lenders did not expand preloan investigations, they would make some unenforceable loans and would suffer forfeitures if they could not pass losses through to borrowers.

The foregoing analysis demonstrates that both the reason to know and strict unenforceability rules would, to some unpredictable degree, increase the cost and decrease the availability of financing for proper activities. By contrast, the knowledge rule (if strictly construed) would have little impact upon the cost or availability of financing for proper activities. In pondering the significance of this conclusion, it is interesting to consider recent developments in the holder in due course doctrine, which, like the traditional rule, is often justified on the ground that it promotes commerce.¹⁴³

Recognizing that the holder in due course doctrine had been subject to abuse in consumer transactions,¹⁴⁴ the Federal Trade Commission (FTC) issued a rule in 1975 that abrogated the doctrine in consumer transactions.¹⁴⁵ Under the FTC Rule, every consumer credit contract must include a notice which warns that any holder of the contract is subject to all claims and defenses¹⁴⁶ that the consumer could assert against the seller.¹⁴⁷ Further, when a lender finances a consumer purchase from a seller who

143. See *supra* text accompanying notes 64–68.

144. Unscrupulous sellers took negotiable paper from consumers in exchange for defective goods and services, then sold this paper to finance companies. Because the finance companies qualified as holders in due course, the consumers were unable to withhold payment for the defective goods and services. For a recital of statistics and anecdotal testimony reflecting the magnitude of consumer injury, see Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,509–14 (1975) [hereinafter Statement].

145. 16 C.F.R. §§ 433.1–433.3 (1989).

The FTC is not the only institution that has attempted to protect consumers by limiting the holder in due course doctrine. The courts have developed a doctrine which holds that a close connection between seller and creditor will disqualify the creditor from holder in due course status. See, e.g., *Commercial Credit Co. v. Childs*, 199 Ark. 1073, 1077, 137 S.W.2d 260, 262 (1940); *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967); see generally *Benson & Squillante, supra* note 67, at 443–49; Comment, *The Close-Connectedness Doctrine: Preserving Consumer Rights in Credit Transactions*, 33 ARK. L. REV. 490, 492–97 (1979). State legislatures have enacted a variety of statutes that restrict or eliminate the holder in due course doctrine in consumer transactions. See, e.g., HAW. REV. STAT. § 476–19 (1985); KAN. STAT. ANN. §§ 16a-3-307, 16a-3-404 (1988); MINN. STAT. ANN. § 325G.16 (West 1981); VT. STAT. ANN. tit. 9, § 2455 (1984); WIS. STAT. ANN. § 422.406 (West 1988).

146. The holder of the consumer credit contract is subject only to those claims or defenses that arise out of the transaction which produced the contract. The contract holder is not subject to claims or defenses arising out of a separate transaction between the consumer and the same seller. Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20,022, 20,024 (1976) [hereinafter Guidelines].

147. This notice reads as follows:

Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

16 C.F.R. § 433.2(a) (1989). A seller who takes or receives a consumer credit contract which does not include this notice commits an unfair or deceptive act or practice within the meaning of § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (1988).

A consumer credit contract containing this notice is not a negotiable instrument because the notice renders the consumer's promise to pay conditional. Thus, the holder of a consumer credit contract that includes the notice cannot be a holder in due course. J. WHITE & R. SUMMERS, *supra* note 67, § 14-8, at 639; Lawrence & Minan, *The Effect of Abrogating the Holder-In-Due-Course Doctrine on the Commercialization of Innovative Consumer Products*, 64 B.U.L. REV. 325, 334 n.34 (1984). A forthcoming article argues persuasively that this elimination of negotiable instruments in consumer transactions is an unnecessarily drastic (and probably unintended) means of restricting the holder in due course

is affiliated with or refers consumers to the lender,¹⁴⁸ the loan contract must contain a notice that states that any holder of the contract (including the lender) is subject to all claims and defenses the consumer could assert against the seller.¹⁴⁹

In its Statement of Basis and Purpose,¹⁵⁰ the FTC evaluated the evidence before it and explained its reasons for adopting the Rule. During the rulemaking process, industry representatives complained that the proposed Rule would burden legitimate commerce by increasing purchase prices and interest rates, and reducing the availability of goods, services, and credit.¹⁵¹ In its Statement, the FTC disagreed with this pessimistic assessment of the Rule's probable consequences. It noted that financial institutions had access to a variety of information regarding seller conduct and were already in the habit of thoroughly investigating such conduct before purchasing consumer paper.¹⁵² Based on the evidence before it, the FTC concluded that the Rule would have little effect upon interest rates and availability of credit.¹⁵³ Although there have been few studies of the Rule's impact, those that exist tend to support this conclusion.¹⁵⁴

Thus, abandonment of the holder in due course doctrine in consumer transactions was facilitated by the belief that the Rule would not impose serious costs upon legitimate trade. Reasoning by analogy, the conclusion that the knowledge rule would not significantly increase the cost or decrease the availability of financing for proper

doctrine. Sturley, *The Legal Impact of the Federal Trade Commission's Holder in Due Course Notice on a Negotiable Instrument: How Clever Are the Rascals at the FTC?*, 68 N.C.L. REV. ____ (1990).

148. For a detailed description of the circumstances under which such a referral or affiliation will be found, see Statement of Enforcement Policy in Regard to Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 34,594 (1976).

149. This notice provides as follows:

Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

16 C.F.R. § 433.2(b) (1989). When the loan contract does not include this notice, a seller who accepts the loan proceeds in payment for goods or services commits an unfair or deceptive act or practice within the meaning of § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (1988).

The notice operates as a contract term, subjecting the lender to claims and defenses that arise out of the nominally separate transaction between the seller and consumer. Lawrence & Minan, *supra* note 147. Extending the FTC Rule to cover direct loans was viewed as necessary in order to prevent the seller from frustrating the underlying policy of preserving consumer claims and defenses simply by "diverting business from the discount window to the loan booth." Statement, *supra* note 144, at 53,515.

150. Statement, *supra* note 144.

151. *Id.* at 53,517-18.

152. *Id.* at 53,518.

153. *Id.* at 53,519-21. Indeed, the FTC carefully tailored the Rule to avoid affecting interest rates and availability of credit. Recognizing that the cost of investigating the practices of an unfamiliar seller could reduce the availability of credit, see Guidelines, *supra* note 146, at 20,025, the FTC extended the Rule to direct loans only when the lender and seller had an established relationship. See 16 C.F.R. §§ 433.1(d), 433.2(b) (1989).

154. The Wharton Forecasting Institute calculated that the Rule caused only a 5.5% reduction in consumer credit in 1976. See Lawrence & Minan, *supra* note 147, at 338 n.51. A 1976 study commissioned by the FTC indicated that the Rule had neither increased interest rates nor produced substantial market dislocations. See Garner & Dunham, *FTC Rule 433 and the Uniform Commercial Code: An Analysis of Current Lender Status*, 43 Mo. L. Rev. 199, 234 (1978). White and Summers note that the Rule has not had the catastrophic impact upon the consumer market predicted by its detractors, and suggest that "twenty years from now we may conclude that [the Rule] caused barely a ripple on the consumer credit pond." J. WHITE & R. SUMMERS, *supra* note 67, § 14-1, at 614.

A recent article, however, contends that the Rule has reduced the availability of financing for innovative consumer products. See Lawrence & Minan, *supra* note 147.

activities supports abandonment of the traditional rule and adoption of the knowledge rule.

C. *Balancing the Costs and Benefits of the Alternative Rules*

The last task of this Article is to weigh the potential costs and benefits of the three alternative rules to determine whether adoption of any of the rules is advisable. The knowledge rule would produce more benefits than the traditional rule. It would protect judicial integrity more effectively by allowing the courts to refuse assistance to lenders which knowingly furthered improper activities. It would also deter borrower misconduct more effectively by encouraging lenders to refuse loans or charge higher interest rates to borrowers known to be engaged in improper activities. At the same time, the knowledge rule would not cost more than the traditional rule. It would not infringe upon individual liberty because there is no freedom to make enforceable loans that further known violations of public policy. Moreover, it would not significantly increase the price or decrease the availability of financing for proper activities. Because the knowledge rule would provide increased benefits at little or no cost, it should be adopted.¹⁵⁵

This analysis assumes that the knowledge rule would be strictly construed. Unfortunately, courts and juries often tend to infer knowledge from surrounding facts and circumstances.¹⁵⁶ Therefore, judicial decisions or statutes which adopt the knowledge rule must be carefully drafted to require solid proof of actual knowledge before enforcement is denied.

The reason to know and strict unenforceability rules would produce more benefits than the knowledge rule. They would protect judicial integrity more effectively by allowing the courts to more often refuse assistance to lenders which financed improper activities. They would also deter borrower misconduct more effectively by encouraging lenders to more often discover improper activities and refuse loans or charge higher interest rates.

Unfortunately, the reason to know and strict unenforceability rules would also impose greater costs than the knowledge rule. The reason to know rule would not infringe upon individual liberty because there is no freedom to make enforceable loans that further foreseeable violations of public policy. However, the strict unenforceability rule could infringe upon liberty, assuming lenders have the freedom to make enforceable loans that further unforeseeable violations of public policy. Moreover, both rules would increase the cost and reduce the availability of financing for proper activities to some unpredictable extent. Because it is impossible to know

155. This conclusion might not hold true if the knowledge rule was applied in cases involving insignificant regulatory violations (e.g., violations of minor provisions such as parking or traffic ordinances, or very slight violations of more important provisions). Some of the very few lenders which discovered insignificant regulatory violations would demand cure, but cure of such minor infractions would produce little societal benefit. Meanwhile, other lenders would simply ignore insignificant regulatory violations. Later, when their loans proved to be unenforceable, they would seek to pass resulting losses through to all borrowers, thereby imposing unwelcome costs upon proper activities. For these reasons, this Article recommends that the knowledge rule not be applied in cases involving insignificant regulatory violations.

156. See *supra* text accompanying notes 79–87.

whether the reason to know and strict unenforceability rules would provide greater benefits than costs, they should not be adopted.

IV. CONCLUSION

When Cain asked the Lord, "Am I my brother's keeper?" there was a certain irony to his question. Even as he denied that he had any duty to look after Abel, Cain knew all too well that his fault did not lie in failure to look after Abel, but rather in murdering him.¹⁵⁷

When a lender asks, "Am I my borrower's keeper?" its question is similarly ironic. The lender which knowingly makes an improper use loan does not simply fail to fulfill some general duty to control the borrower for the good of individuals and society. Instead, it actively facilitates the borrower's violation of public policy, thereby harming individuals and society. Nevertheless, present law allows the lender to enforce its loan and any concomitant security interest.

The courts and legislatures should adopt a new rule that would preclude enforcement whenever a lender knowingly financed an improper activity. This rule would not require any lender to act as its borrower's keeper. It would, however, make clear that every lender must bear responsibility for the known consequences of its own conduct.

157. See *Genesis* 4:3-9 (King James).

